TAX LAW SIMPLIFICATION AND IMPROVEMENT ACT OF 1983

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

ON

H.R. 3475

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO SIMPLIFY AND IMPROVE THE TAX LAWS

JULY 25, 1983

Serial 98-40

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
27-005 O WASHINGTON : 1983

H781-25

COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida
J. J. PICKLE, Texas
CHARLES B. RANGEL, New York
FORTNEY H. (PETE) STARK, California
JAMES R. JONES, Oklahoma
ANDY JACOBS, Jr., Indiana
HAROLD FORD, Tennessee
ED JENKINS, Georgia
RICHARD A. GEPHARDT, Missouri
THOMAS J. DOWNEY, New York
CECIL (CEC) HEFTEL, Hawaii
WYCHE FOWLER, Jr., Georgia
FRANK J. GUARINI, New Jersey
JAMES M. SHANNON, Massachusetts
MARTY RUSSO, Illinois
DON J. PEASE, Ohio
KENT HANCE, Texas
ROBERT T. MATSUI, California
BERYL ANTHONY, Jr., Arkansas
RONNIE G. FLIPPO, Alabama
BYRON L. DORGAN, North Dakota
BARBARA B. KENNELLY, Connecticut

BARBER B. CONABLE, Jr., New York
JOHN J. DUNCAN, Tennessee
BILL ARCHER, Texas
GUY VANDER JAGT, Michigan
PHILIP M. CRANE, Illinois
BILL FRENZEL, Minnesota
JAMES G. MARTIN, North Carolina
RICHARD T. SCHULZE, Pennsylvania
BILL GRADISON, Ohio
W. HENSON MOORE, Louisiana
CARROLL A. CAMPBELL, Jr., South Carolina
WILLIAM M. THOMAS, California

John J. Salmon, *Chief Counsel*
Joseph K. Dowley, *Assistant Chief Counsel*
Robert J. Leonard, *Chief Tax Counsel*
A. L. Singleton, *Minority Chief of Staff*

CONTENTS

Page

Press release of Monday, July 11, 1983, announcing hearing 1
H.R. 3475, text 3

WITNESSES

Department of the Treasury, Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy) 150
General Accounting Office, Johnny C. Finch, Associate Director, General Government Division, and Kane Wong, Senior Evaluator 185
U.S. Tax Court, Hon. Howard A. Dawson, Jr., Chief Judge, Hon. John J. Pajak, Special Trial Judge, and Charles Casazza, Clerk of the Court 196

Aidinoff, M. Bernard, Section of Taxation, American Bar Association 203
Aluminum Co. of America, Albert E. Germain and Ernest S. Christian, Jr 244
American Bar Association, section of taxation, M. Bernard Aidinoff and James Jones 203
Castle & Cooke, Inc., Sol Coffino 230
Christian, Ernest S., Jr., Aluminum Co. of America 244
Coffino, Sol, Castle & Cooke, Inc., on behalf of Tax Executives Institute, Inc 230
Colt Industries, Inc., Jules Levinson and George Webster 285
Germain, Albert E., Aluminum Co. of America 244
Glickman, David, Southwest Small Business Study Group, and Sammons Enterprises, Inc 287
Government Research and Development Foundation, Jim Jones 278
Harmon, Gail, Women's Legal Defense Fund and Women's Equity Action League 269
Hughes, Vester T., Jr., Southwest Small Business Study Group, and Sammons Enterprises, Inc 287
Jones, James, Section of Taxation, American Bar Association 203
Jones, Jim, Government Research and Development Foundation 278
Lehrfeld, William J., Shriners Hospitals for Crippled Children 300
Levinson, Jules, Colt Industries, Inc 285
Massman, Richard, Southwest Small Business Study Group, and Sammons Enterprises, Inc 287
National Association of Enrolled Agents, David J. Silverman 274
O'Connell, Marjorie A., Washington, D.C 263
Sammons Enterprises, Inc., Vester T. Hughes, Jr., Richard Massman, David Glickman, and David Sinak 287
Shriners Hospitals for Crippled Children, William J. Lehrfeld 300
Silverman, David J., National Association of Enrolled Agents 274
Sinak, David, Southwest Small Business Study Group, and Sammons Enterprises, Inc 287
Southwest Small Business Study Group, Vester T. Hughes, Jr., Richard Massman, David Glickman, and David Sinak 287
Tax Executives Institute, Inc., Sol Coffino 230
Tillinghast, David R., New York, N.Y 226
Webster, George, Colt Industries, Inc 285
Women's Equity Action League, Gail Harmon 269
Women's Legal Defense Fund, Gail Harmon 269

SUBMISSIONS FOR THE RECORD

Abbin, Byrle M., Arthur Andersen & Co., letter and attachment 331
Allegheny International, Inc., statement 315
American Institute of Certified Public Accountants, statement 318

Page
Amfac, Inc., statement ... 321
Arnold and Porter, Joseph H. Guttentag, Stanford G. Ross, joint statement ... 328
Arthur Andersen & Co., Byrle M. Abbin, letter and attachment ... 331
Asimow, Michael, University of California, Los Angeles, Calif., letter ... 338
Banking, Finance and Urban Affairs, Committee on, Hon. Fernand J. St Germain, letter ... 340
Bernstein, Rachelle B., Chamber of Commerce of the United States of America, statement ... 341
Blattmachr, Jonathan G., New York State Bar Association, Trusts and Estates Law Section, statement ... 365
Brown, William W., Redding, Calif., statement ... 341
Chamber of Commerce of the United States of America, Rachelle B. Bernstein, statement ... 341
Curry, Kathleen, National Association of Independent Colleges and Universities, letter ... 355
Edison Electric Institute, Walker F. Nolan, letter ... 344
Employee Stock Ownership Association, Luis Granados, statement ... 346
Enventure Capital Group, Inc., statement ... 347
Fitch, John H., Jr., National Association of Wholesaler-Distributors, letter ... 360
Gideon, Kenneth W., Washington, D.C., letter ... 349
Goss, Frederick D., Newsletter Association, statement and attachment ... 362
Granados, Luis, Employee Stock Ownership Association, statement ... 346
Greenberg, Samuel, One Tax Alliance, letter ... 368
Guttentag, Joseph H., Arnold & Porter, statement ... 328
Hammer, Richard M., Price Waterhouse, letter ... 373
Hughes, Robert J., Jr., New York State Bar Association, Trusts and Estates Law Section, letter ... 365
Investment Company Institute, statement ... 349
Kelly, R. P., Price Waterhouse, letter ... 371
Langer, Marshall J., Shutts & Bowen, statement ... 350
McDonald, Randall J., Schwartz, Davenport & Schwendimann, letter ... 377
McKinley, Royce B., Santa Anita Realty Enterprises, Inc., Santa Anita Operating Co., letter ... 374
National Association of Enrolled Federal Tax Accountants, S. A. Rish, letters and attachments ... 353
National Association of Independent Colleges & Universities, Kathleen Curry, letter ... 355
National Association of Real Estate Investment Trusts, Inc., statement ... 356
National Association of Wholesaler-Distributors, John H. Fitch, Jr. letter ... 360
National Society of Public Accountants, statement ... 361
Newsletter Association, Frederick D. Goss, statement and attachment ... 362
New York State Bar Association:
  Jonathan G. Blattmachr, Trusts and Estates Law Section, statement ... 365
  Robert J. Hughes, Jr., Trusts and Estates Law Section, letter ... 365
  Willard B. Taylor, Tax Section, letter ... 366
Nolan, Walker F., Edison Electric Institute, letter ... 344
One Tax Alliance, Samuel Greenberg, letter ... 368
Panetta, Hon. Leon E., a Representative in Congress from the State of California, statement ... 368
Pepper, Hon. Claude, a Representative in Congress from the State of Florida, letter ... 370
Price Waterhouse:
  Richard M. Hammer, letter ... 373
  R. P. Kelly, letter ... 371
Rish, S. A., National Association of Enrolled Federal Tax Accountants, letters and attachment ... 353
Ross, Stanford G., Arnold & Porter, statement ... 328
Santa Anita Realty Enterprises, Inc., Santa Anita Operating Co., Royce B. McKinley, letter ... 374
Shutts and Bowen, Marshall J. Langer, statement ... 350
Schwartz, Davenport & Schwendimann, Randall J. McDonald, letter ... 377
St Germain, Fernand J., a Representative in Congress from the State of Rhode Island, Committee on Banking, Finance and Urban Affairs, letter ... 340
Taylor, Willard B., New York State Bar Association, Tax Section, letter ... 366
White, Robert B., Coral Gables, Fla., statement ... 380

TAX LAW SIMPLIFICATION AND IMPROVEMENT ACT OF 1983

MONDAY, JULY 25, 1983

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 10:10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearing and a copy of the bill, H.R. 3475, follow:]

[Press release of Monday, July 11, 1983]

Hon. Dan Rostenkowski (D.-Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives Announces Hearing on H.R. 3475, the Tax Law Simplification and Improvement Act of 1983

Hon. Dan Rostenkowski (D.-Ill.), chairman of the Committee on Ways and Means, U.S. House of Representatives, announced today that the committee will hold a public hearing on July 25, 1983, beginning at 10 a.m., in the committee's main hearing room, 1100 Longworth House Office Building, to receive testimony on H.R. 3475, the Tax Law Simplification and Improvement Act of 1983, introduced by Chairman Rostenkowski and Hon. Barber B. Conable, Jr. on June 30, 1983.

Upon introduction of this measure, Chairman Rostenkowski noted: "This legislation culminates months of effort by our congressional staff in identifying major problem areas in the law and developing proposed solutions in a collaborative process. Mr. Conable and I wish to express our gratitude to those groups such as the American Bar Association and the American Institute of Certified Public Accountants that suggested areas for study, proposed solutions, and deliberated with our staff to develop the product we are introducing."

In announcing this hearing, Chairman Rostenkowski observed that "The primary importance of this measure is the attempt it represents to simplify some of the rules in the tax law which affect large numbers of average individual and business taxpayers. Unfortunately, the tax legislative process does not always provide an opportunity for necessary simplification efforts. I hope this current proposal will not be jeopardized by attracting nongermane amendments. In addition, I expect that every effort will be made to assure that this bill does not become a vehicle for broader or unrelated policy changes."

BACKGROUND

H.R. 3475 contains nine titles, as follows (for a detailed technical explanation, see the Congressional Record of June 30, 1983, page H 4881):

Title I. Estimated tax revisions.—Title I contains a major and long overdue revision of the estimated tax provisions for individuals.

Title II. Domestic relations.—Title II includes revisions to the rules which govern the tax treatment of property transfers at divorce, alimony payments, and the dependency exemption for children of divorced parents as well as amendments to the so-called innocent spouse rules.

Title III. At-risk revisions.—Title III represents an attempt to simplify and clarify the investment tax credit at-risk limitation added by the Economic Recovery Tax Act of 1981 [ERTA].

Title IV. Estate tax provisions.—Title IV contains two changes related to the estate tax provisions. One solves a long-standing difficulty related to charitable split interest transfers. Second, the law would be amended to better effectuate the original purpose of the alternate valuation provision of present law.

Title V. Foreign provisions.—Title V would make several changes in the present provisions affecting foreign taxpayers. One is a much needed definition of "resident alien." Several provisions are included to clarify and improve the foreign personal holding company rules. Code section 1248 would be amended to liberalize present law with regard to accumulated earnings and profits of a controlled foreign corporation [CFC]. This title also contains provisions to deal with a long-standing problem regarding so-called stapled stock.

Title VI. Miscellaneous Treasury administrative provisions.—Title VI contains a number of minor provisions recommended by the Department of the Treasury as changes that would simplify or improve their operations.

Title VII. Tax Court provisions.—Title VII includes several noncontroversial changes requested by the Tax Court, and a more substantive proposal designed to improve the representation of taxpayers involved in small cases before the court.

Title VIII. Simplification of income tax credits.—Title VIII would simplify and rationalize the income tax credit provisions in the Internal Revenue Code. The credits would be grouped into logical categories and the various rules concerning limitations and carryovers would be conformed and simplified.

Title IX. Deadwood provisions.—Title XI repeals several obsolete provisions of the Internal Revenue Code.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony before the committee must submit their requests to be heard in writing no later than the close of business, Tuesday, July 19, 1983, to John J. Salmon, chief counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

In order to assure the most productive use of the limited amount of time available to question witnesses, witnesses scheduled to appear before the commmittee are required to submit 200 copies of their prepared statements to the committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearances.

Each statement to be presented to the committee or any written statement submitted for the record must contain the following information:

1. The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);
2. A list of any clients or persons, or any organization for whom the witness appears; and
3. A topical outline or summary of comments and recommendations.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, six copies are required and may be submitted by the close of business Friday, July 29, 1983, to John J. Salmon, chief counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the committee office before the hearing begins.

98TH CONGRESS
1ST SESSION

H. R. 3475

To amend the Internal Revenue Code of 1954 to simplify and improve the tax laws.

IN THE HOUSE OF REPRESENTATIVES

JUNE 30, 1983

Mr. ROSTENKOWSKI (for himself and Mr. CONABLE) introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 to simplify and improve the tax laws.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; ETC.

(a) SHORT TITLE.—This Act may be cited as the "Tax Law Simplification and Improvement Act of 1983".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

(c) TABLE OF CONTENTS.—

Sec. 1. Short title; etc.

TITLE I—REVISION AND SIMPLIFICATION OF ESTIMATED INCOME TAX FOR INDIVIDUALS

Sec. 101. Revision of penalty for failure to pay estimated income tax.
Sec. 102. Repeal of requirement of declarations, etc.
Sec. 103. Effective date.

TITLE II—DOMESTIC RELATIONS

Sec. 201. Short title.
Sec. 202. Treatment of transfers of property between spouses or incident to divorce.
Sec. 203. Tax treatment of alimony and separate maintenance payments.
Sec. 204. Dependency exemption in the case of child of divorced parents, etc.
Sec. 205. Innocent spouse relieved of liability in certain cases.
Sec. 206. Deduction allowed against estate tax for transfers satisfying section 2516.

TITLE III—REVISION OF AT-RISK RULES FOR THE INVESTMENT TAX CREDIT

Sec. 301. Revision of at-risk rules.

TITLE IV—ESTATE TAX PROVISIONS

Sec. 401. Permanent rules for reforming governing instruments creating charitable remainder trusts and other charitable interests.
Sec. 402. Alternate valuation election available only where it results in reduction of gross estate and estate tax.
Sec. 403. Alternate valuation election available on late return.

TITLE V—FOREIGN TAX PROVISIONS

Sec. 501. Definition of resident alien and nonresident alien.
Sec. 502. Treatment of community income.
Sec. 503. Amendments related to foreign personal holding companies.
Sec. 504. Amendments related to section 1248.
Sec. 505. Coordination of subpart F with foreign personal holding company provisions.
Sec. 506. Stapled stock; stapled entities.

TITLE VI—MISCELLANEOUS TREASURY ADMINISTRATIVE PROVISIONS

Sec. 601. Simplification of certain reporting requirements.
Sec. 602. Removal of $1,000,000 limitation on working capital fund.
Sec. 603. Increase in limitation on revolving fund for redemption of real property.
Sec. 604. Secretary of the Treasury authorized to accept gifts and bequests.
Sec. 605. Repeal of stamp requirements for distilled spirits.

Sec. 606. Extension of period for court review of jeopardy assessment where prompt service not made on Secretary.

TITLE VII—TAX COURT PROVISIONS

Sec. 701. Certified public accountants and enrolled agents authorized to represent taxpayers in small tax cases.
Sec. 702. Annuities to survivors of Tax Court judges.
Sec. 703. Proceedings which may be assigned to commissioners.
Sec. 704. Special trial judges.
Sec. 705. Publicity of Tax Court proceedings.

TITLE VIII—SIMPLIFICATION OF INCOME TAX CREDITS

Sec. 801. Short title.
Sec. 802. Credits grouped together in more logical order.
Sec. 803. Uniform limitation on personal nonrefundable credits.
Sec. 804. Uniform carryover provisions for business-related credits.
Sec. 805. Technical and conforming amendments.
Sec. 806. Effective dates.

TITLE IX—REPEAL OF CERTAIN OBSOLETE PROVISIONS

Sec. 901. Termination of rules relating to qualified bond purchase plans and retirement bonds with respect to bonds issued after December 31, 1983.
Sec. 902. Repeal of rules relating to gains from disposition of property used in farming where farm losses offset nonfarm income.

TITLE I—REVISION AND SIMPLIFICATION OF ESTIMATED INCOME TAX FOR INDIVIDUALS

SEC. 101. REVISION OF PENALTY FOR FAILURE TO PAY ESTIMATED INCOME TAX.

Section 6654 (relating to addition to the tax for failure by individual to pay estimated income tax) is amended to read as follows:

"SEC. 6654. FAILURE BY INDIVIDUAL TO PAY ESTIMATED INCOME TAX.

"(a) ADDITION TO THE TAX.—Except as otherwise provided in this section, in the case of any underpayment of estimated tax by an individual, there shall be added to the tax under chapter 1 and the tax under chapter 2 for the taxable year an amount determined by applying—

"(1) the applicable annual rate established under section 6621,

"(2) to the amount of the underpayment,

"(3) for the period of the underpayment.

"(b) AMOUNT OF UNDERPAYMENT; PERIOD OF UNDERPAYMENT.—For purposes of subsection (a)—

"(1) AMOUNT.—The amount of the underpayment shall be the excess of—

"(A) the required installment, over

"(B) the amount (if any) of the installment paid on or before the due date for the installment.

"(2) PERIOD OF UNDERPAYMENT.—The period of the underpayment shall run from the due date for the installment to whichever of the following dates is the earlier—

"(A) the 15th day of the 4th month following the close of the taxable year, or

"(B) with respect to any portion of the underpayment, the date on which such portion is paid.

"(3) ORDER OF CREDITING PAYMENTS.—For purposes of paragraph (2)(B), a payment of estimated tax shall be credited against unpaid required installments in the order in which such installments are required to be paid.

"(c) Number of Required Installments; Due Dates.—For purposes of this section—

"(1) Payable in 4 installments.—There shall be 4 required installments for each taxable year.

"(2) Time for payment of installments.—

"In the case of the following required installments:	The due date is:
1st	April 15
2nd	July 15
3rd	September 15
4th	January 15 of the following taxable year.

"(d) Amount of Required Installments.—For purposes of this section—

"(1) Amount.—

"(A) In general.—Except as provided in paragraph (2), the amount of any required installment shall be 25 percent of the required annual payment.

"(B) Required annual payment.—For purposes of subparagraph (A), the term 'required annual payment' means the lesser of—

"(i) 80 percent of the tax shown on the return for the taxable year (or, if no return is filed, 80 percent of the tax for such year), or "(ii) 100 percent of the tax shown on the return of the individual for the preceding taxable year.

Clause (ii) shall not apply if the preceding taxable year was not a taxable year of 12 months or if the individual did not file a return for such preceding taxable year.

"(2) LOWER REQUIRED INSTALLMENT WHERE ANNUALIZED INCOME INSTALLMENT IS LESS THAN AMOUNT DETERMINED UNDER PARAGRAPH (1).—

"(A) IN GENERAL.—In the case of any required installment, if the individual establishes that the annualized income installment is less than the amount determined under paragraph (1)—

"(i) the amount of such required installment shall be the annualized income installment, and

"(ii) any reduction in a required installment resulting from the application of this subparagraph shall be recaptured by increasing the amount of the next required installment determined under paragraph (1) by the amount of such reduction (and by increasing subsequent required installments to the extent that the reduction has not previously been recaptured under this clause).

"(B) Determination of annualized income installment.—In the case of any required installment, the annualized income installment is the excess (if any) of—

"(i) an amount equal to the applicable percentage of the tax for the taxable year computed by placing on an annualized basis the taxable income and adjusted self-employment income for months in the taxable year ending before the due date for the installment, over

"(ii) the aggregate amount of any prior required installments for the taxable year.

"(C) Special rules.—For purposes of this paragraph—

"(i) Annualization.—The taxable income and adjusted self-employment income shall be placed on an annualized basis under regulations prescribed by the Secretary.

"(ii) Applicable percentage.—

"In the case of the following required installments:	The applicable percentage is:
1st	20
2nd	40
3rd	60
4th	80

"(iii) ADJUSTED SELF-EMPLOYMENT INCOME.—The term 'adjusted self-employment income' means self-employment income (as defined in section 1402(b)); except that section 1402(b) shall be applied by placing wages (within the meaning of section 1402(b)) for months in the taxable year ending before the due date for the installment on an annualized basis consistent with clause (i).

"(3) EFFECT OF ADJUSTMENTS IN PRIOR YEAR TAX.—If, before the due date for any required installment, the amount of tax shown on the return of the individual for the preceding taxable year was—

"(A) adjusted by the taxpayer, or

"(B) adjusted by the Secretary and such adjustment became final,

the amount of tax taken into account for purposes of paragraph (1)(B)(ii) shall be the amount determined after such adjustment.

"(e) EXCEPTIONS.—

"(1) WHERE TAX IS SMALL AMOUNT.—No addition to tax shall be imposed under subsection (a) for any taxable year if the tax shown on the return for such taxable year (or, if no return is filed, the tax), reduced by the credit allowable under section 31, is less than $500 ($400 in the case of taxable years beginning during 1984).

"(2) WHERE NO TAX LIABILITY FOR PRECEDING TAXABLE YEAR.—No addition to tax shall be imposed under subsection (a) for any taxable year if—

"(A) the preceding taxable year was a taxable year of 12 months,

"(B) the individual did not have any liability for tax for the preceding taxable year, and

"(C) the individual was a citizen or resident of the United States throughout the preceding taxable year.

"(3) REASONABLE CAUSE.—No addition to tax shall be imposed under subsection (a) with respect to any underpayment to the extent it is established to the satisfaction of the Secretary that such underpayment is due to reasonable cause and not to willful neglect.

"(f) TAX COMPUTED AFTER APPLICATION OF CREDITS AGAINST TAX.—For purposes of this section, the term 'tax' means—

"(1) the tax imposed by chapter 1 (other than by section 55), plus

"(2) the tax imposed by chapter 2, minus

"(3) the sum of—

"(A) the credits against tax allowed by part IV of subchapter A of chapter 1, other than the credit against tax provided by section 31 (relating to tax withheld on wages, interest, dividends, and patronage dividends), plus

"(B) to the extent allowed under regulations prescribed by the Secretary, any overpayment of the tax imposed by section 4986 (determined without regard to section 4995(a)(4)(B)).

"(g) APPLICATION OF SECTION IN CASE OF TAX WITHHELD ON WAGES.—

"(1) IN GENERAL.—For purposes of applying this section, the amount of the credit allowed under section 31 for the taxable year shall be deemed a payment of estimated tax, and an equal part of such amount shall be deemed paid on each due date for such taxable year, unless the taxpayer establishes the dates on which all amounts were actually withheld, in which case the amounts so withheld shall be deemed payments of estimated tax on the dates on which such amounts were actually withheld.

"(2) SEPARATE APPLICATION.—The taxpayer may apply paragraph (1) separately with respect to—

"(A) wage withholding, and

"(B) all other amounts withheld for which credit is allowed under section 31.

"(h) Special Rule Where Return Filed on or Before January 31.—If, on or before January 31 of the following taxable year, the taxpayer files a return for the taxable year and pays in full the amount computed on the return as payable, then no addition to tax shall be imposed under subsection (a) with respect to any underpayment of the 4th required installment for the taxable year.

"(i) Special Rules for Farmers and Fishermen.—For purposes of this section—

"(1) In general.—If an individual is a farmer or fisherman for any taxable year—

"(A) there shall be only 1 required installment for the taxable year,

"(B) the due date for such installment shall be January 15 of the following taxable year,

"(C) the amount of such installment shall be equal to the required annual payment (determined under subsection (d)(1)(B) by substituting '66⅔ percent' for '80 percent', and

"(D) subsection (h) shall be applied—

"(i) by substituting 'March 1' for 'January 31', and "(ii) by treating the required installment described in subparagraph (A) of this paragraph as the 4th required installment.

"(2) FARMER OR FISHERMAN DEFINED.—An individual is a farmer or fisherman for any taxable year if—

"(A) the individual's gross income from farming or fishing (including oyster farming) for the taxable year is at least 66⅔ percent of the total gross income from all sources for the taxable year, or

"(B) such individual's gross income from farming or fishing (including oyster farming) shown on the return of the individual for the preceding taxable year is at least 66⅔ percent of the total gross income from all sources shown on such return.

"(j) FISCAL YEARS AND SHORT YEARS.—

"(1) FISCAL YEARS.—In applying this section to a taxable year beginning on any date other than January 1, there shall be substituted, for the months specified in this section, the months which correspond thereto.

"(2) SHORT TAXABLE YEAR.—This section shall be applied to taxable years of less than 12 months in accordance with regulations prescribed by the Secretary.

"(k) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section."

SEC. 102. REPEAL OF REQUIREMENT OF DECLARATIONS, ETC.

(a) GENERAL RULE.—The following provisions are hereby repealed.

(1) Section 6015 (relating to declaration of estimated income tax by individuals).

(2) Section 6073 (relating to time for filing declarations of estimated income tax by individuals).

(3) Section 6153 (relating to installment payments of estimated income tax by individuals).

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subsection (g) of section 871 is amended by striking out paragraph (6) and by redesignating paragraphs (7) and (8) as paragraphs (6) and (7), respectively.

(2) Subsection (b) of section 1403 is amended by striking out paragraph (3).

(3) Paragraph (2) of section 6012(b) is amended by striking out "or section 6015(a)".

(4) Paragraph (1) of section 6020(b) is amended by striking out "(other than a declaration of estimated tax required under section 6015)".

(5) Paragraph (1) of section 6201(b) is amended to read as follows:

"(1) ESTIMATED INCOME TAX.—No unpaid amount of estimated income tax required to be paid under section 6154 or 6654 shall be assessed."

(6) Paragraph (5) of section 6362(e) is amended by striking out "and section 6015 and other provisions relating to declarations of estimated income" and inserting in lieu thereof "and provisions relating to estimated income tax".

(7) Subsection (h) of section 6601 is amended to read as follows:

"(h) EXCEPTION AS TO ESTIMATED TAX.—This section shall not apply to any failure to pay any estimated tax required to be paid by section 6154 or 6654."

(8) Subsection (d) of section 6651 is amended to read as follows:

"(d) EXCEPTION FOR ESTIMATED TAX.—This section shall not apply to any failure to pay any estimated tax required to be paid by section 6154 or 6654."

(9) Section 7203 is amended by striking out "(other than a return required under the authority of section 6015)".

(10) Subsection (a) of section 7216 is amended—

(A) by striking out "or declarations or amended declarations of estimated tax under section 6015,", and

(B) by striking out "return or declaration" and inserting in lieu thereof "return".

(11) Paragraph (34) of section 7701(a) is hereby repealed.

(c) CLERICAL AMENDMENTS.—

(1) The table of sections for subpart B of part II of subchapter A of chapter 61 is amended by striking out the item relating to section 6015.

(2) The table of sections for part V of subchapter A of chapter 61 is amended by striking out the item relating to section 6073.

(3) The table of sections for subchapter A of chapter 62 is amended by striking out the item relating to section 6153.

SEC. 103. EFFECTIVE DATE.

The amendments made by this title shall apply with respect to taxable years beginning after December 31, 1983.

TITLE II—DOMESTIC RELATIONS

SEC. 201. SHORT TITLE.

This title may be cited as the "Domestic Relations Tax Reform Act of 1983".

SEC. 202. TREATMENT OF TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

(a) GENERAL RULE.—Part III of subchapter O of chapter 1 (relating to common nontaxable exchanges) is amended by adding at the end thereof the following new section:

"SEC. 1041. TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE.

"(a) GENERAL RULE.—No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)—

"(1) a spouse, or

"(2) a former spouse, but only if the transfer is incident to the divorce.

"(b) TRANSFER TREATED AS GIFT; TRANSFEREE HAS TRANSFEROR'S BASIS.—In the case of any transfer of property described in subsection (a)—

"(1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and

"(2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

"(c) INCIDENT TO DIVORCE.—For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer—

"(1) occurs within 1 year after the date on which the marriage ceases, or

"(2) is related to the cessation of the marriage."

(b) TECHNICAL AMENDMENTS.—

(1) Subsection (k) of section 72 (relating to payments in discharge of alimony) is hereby repealed.

(2) Subsection (e) of section 101 (relating to alimony, etc., payments) is hereby repealed.

(3) COORDINATION WITH SECTION 1015.—Section 1015 (relating to basis of property acquired by gifts and transfers in trust) is amended by adding at the end thereof the following new subsection:

"(e) GIFTS BETWEEN SPOUSES.—In the case of any property acquired by gift in a transfer described in section 1041(a), the basis of such property in the hands of the transferee shall be determined under section 1041(b) and not this section."

(4) COORDINATION WITH SECTION 1239.—Subsection (b) of section 1239 is amended to read as follows:

"(b) **Related Persons.**—For purposes of subsection (a), the term 'related person' means a person and all entities which are 80-percent owned entities with respect to such person."

(c) **Clerical Amendment.**—The table of sections for such part III is amended by adding at the end thereof the following:

"Sec. 1041. Transfers of property between spouses or incident to divorce."

(d) **Effective Dates.**—

(1) **In general.**—Except as provided in paragraph (2), the amendments made by this section shall apply to transfers after the date of the enactment of this Act in taxable years ending after such date.

(2) **Exception for transfers pursuant to existing decrees.**—The amendments made by this section shall not apply to transfers under any instrument in effect on or before the date of the enactment of this Act unless both spouses or former spouses elect to have such amendments apply to transfers under such instrument. Any such election shall be made in such manner, at such time, and subject to such conditions, as the Secretary of the Treasury or his delegate may by regulations prescribe.

SEC. 203. TAX TREATMENT OF ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

(a) General Rule.—Section 71 (relating to alimony and separate maintenance payments) is amended to read as follows:

"SEC. 71. ALIMONY AND SEPARATE MAINTENANCE PAYMENTS.

"(a) General Rule.—Gross income includes amounts received as alimony or separate maintenance payments.

"(b) Alimony or Separate Maintenance Payments Defined.—For purposes of this section—

"(1) In general.—The term 'alimony or separate maintenance payment' means any payment in cash if—

"(A) such payment is received by a spouse under a divorce or separation instrument,

"(B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,

"(C) such payment is not made for a transfer of property by the payee spouse,

"(D) the payee spouse and the payor spouse are not members of the same household at the time such payment is made, "(E) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse, and

"(F) such payment is 1 of a series of cash payments where it is reasonable to expect at least 50 percent of the amount payable under such series will be paid more than 1 year after the date on which the first of such payments is made.

Subparagraph (F) shall not apply to any payment received under a decree described in paragraph (2)(C).

"(2) DIVORCE OR SEPARATION INSTRUMENT.—The term 'divorce or separation instrument' means—

"(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,

"(B) a written separation agreement, or

"(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

"(c) PAYMENTS TO SUPPORT MINOR CHILDREN.—Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of minor children of the spouses. For purposes of the preceding sentence, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

"(d) SPOUSE.—For purposes of this section, the term 'spouse' includes a former spouse.

"(e) EXCEPTION FOR JOINT RETURNS.—This section and section 215 shall not apply if the spouses make a joint return."

(b) AMENDMENT OF SECTION 215.—Section 215 (relating to deduction for alimony, etc., payments) is amended to read as follows:

"SEC. 215. ALIMONY, ETC., PAYMENTS.

"(a) GENERAL RULE.—In the case of an individual, there shall be allowed as a deduction an amount equal to alimony or separate maintenance payments paid during such individual's taxable year.

"(b) ALIMONY OR SEPARATE MAINTENANCE PAYMENTS DEFINED.—For purposes of this section, the term 'alimony or separate maintenance payments' means any alimony or separate maintenance payment (as defined in section

71(b)) which is includible in the gross income of the recipient under section 71.

"(c) REQUIREMENT OF IDENTIFICATION NUMBER.—The Secretary may prescribe regulations under which—

"(1) any individual receiving alimony or separate maintenance payments is required to furnish such individual's taxpayer identification number to the individual making such payments, and

"(2) the individual making such payments is required to include such taxpayer identification number on such individual's return for the taxable year in which such payments are made.

"(d) COORDINATION WITH SECTION 682.—No deduction shall be allowed under this section with respect to any payment if, by reason of section 682 (relating to income of alimony trusts), the amount thereof is not includible in such individual's gross income."

(c) PENALTY FOR FAILURE TO SUPPLY IDENTIFYING NUMBER.—

(1) Section 6676 (relating to failure to supply identifying number) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) PENALTY FOR FAILURE TO SUPPLY IDENTIFYING NUMBER UNDER SECTION 215.—If any person who is required by regulations prescribed under section 215—

"(1) to furnish his taxpayer identification number to another person, or

"(2) to include on his return the taxpayer identification number of another person,

fails to comply with such requirement at the time prescribed by such regulations, such person shall, unless it is shown that such failure is due to reasonable cause and not to willful neglect, pay a penalty of $50 for each such failure."

(2) Subsection (c) of section 6676 (as redesignated by paragraph (1)) is amended by striking out "subsection (a)" and inserting in lieu thereof "subsection (a) or (b)".

(d) TECHNICAL AMENDMENT.—Subsection (b) of section 682 (relating to income of an estate or trust in case of divorce, etc.) is amended—

(1) by striking out "or section 71", and

(2) by striking out the last sentence.

(e) EFFECTIVE DATE.—

(1) IN GENERAL.—The amendments made by this section shall apply with respect to divorce or separation instruments (as defined in section 71(b)(2) of the

Internal Revenue Code of 1954, as amended by this section) executed after December 31, 1983.

(2) MODIFICATIONS OF INSTRUMENTS EXECUTED BEFORE JANUARY 1, 1984.—The amendments made by this section shall also apply to any divorce or separation instrument (as so defined) executed before January 1, 1984, but modified on or after such date if the modification expressly provides that the amendments made by this section shall apply to such modification.

SEC. 204. DEPENDENCY EXEMPTION IN THE CASE OF CHILD OF DIVORCED PARENTS, ETC.

(a) GENERAL RULE.—Subsection (e) of section 152 (relating to support test in case of child of divorced parents, etc.) is amended to read as follows:

"(e) SUPPORT TEST IN CASE OF CHILD OF DIVORCED PARENTS, ETC.—

"(1) CUSTODIAL PARENT GETS EXEMPTION.—Except as otherwise provided in this subsection, if—

"(A) a child (as defined in section 151(e)(3)) receives over half of his support during the calendar year from his parents—

"(i) who are divorced or legally separated under a decree of divorce or separate maintenance, "(ii) who are separated under a written separation agreement, or

"(iii) who live apart at all times during the last 6 months of the calendar year, and

"(B) such child is in the custody of one or both of his parents for more than one-half of the calendar year,

such child shall be treated, for purposes of subsection (a), as receiving over half of his support during the calendar year from the parent having custody for a greater portion of the calendar year (hereinafter in this subsection referred to as the 'custodial parent').

"(2) EXCEPTION WHERE CUSTODIAL PARENT RELEASES CLAIM TO EXEMPTION FOR THE YEAR.—A child of parents described in paragraph (1) shall be treated as having received over half of his support during a calendar year from the noncustodial parent if—

"(A) the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year, and

"(B) the noncustodial parent attaches such written declaration to the noncustodial parent's return for the taxable year beginning during such calendar year.

For purposes of this subsection, the term 'noncustodial parent' means the parent who is not the custodial parent.

"(3) EXCEPTION FOR MULTIPLE-SUPPORT AGREEMENT.—This subsection shall not apply in any case where over half of the support of the child is treated as having been received from a taxpayer under the provisions of subsection (c).

"(4) EXCEPTION FOR CERTAIN PRE-1984 INSTRUMENTS.—

"(A) IN GENERAL.—A child of parents described in paragraph (1) shall be treated as having received over half his support during a calendar year from the noncustodial parent if—

"(i) a qualified pre-1984 instrument between the parents applicable to the taxable year beginning in such calendar year provides that the noncustodial parent shall be entitled to any deduction allowable under section 151 for such child, and "(ii) the noncustodial parent provides at least $600 for the support of such child during such calendar year.

For purposes of this subparagraph, amounts expended for the support of a child or children shall be treated as received from the noncustodial parent to the extent that such parent provided amounts for such support.

"(B) QUALIFIED PRE-1984 INSTRUMENT.—For purposes of this paragraph, the term 'qualified pre-1984 instrument' means any decree of divorce or separate maintenance or written agreement—

"(i) which is executed before January 1, 1984, and

"(ii) which on such date contains the provision described in subparagraph (A)(i).

"(5) CROSS REFERENCE.—

"For provision treating child as dependent of both parents for purposes of medical expense deduction, see section 213(d)(4)."

(b) TREATMENT AS DEPENDENT OF BOTH PARENTS FOR MEDICAL EXPENSE DEDUCTION.—

(1) Subsection (d) of section 213 (relating to definitions) is amended by redesignating paragraphs (4), (5), and (6) as paragraphs (5), (6), and (7), respectively, and by inserting after paragraph (3) the following new paragraph:

"(4) SPECIAL RULE IN THE CASE OF CHILD OF DIVORCED PARENTS, ETC.—Any child to whom section 152(e) applies shall be treated as a dependent of both parents for purposes of this section."

(2) Paragraph (6) of section 213(d) (as redesignated by paragraph (1)) is amended by striking out "the limitations of paragraph (2)" and inserting in lieu thereof "the limitations of paragraph (5)".

(c) TREATMENT OF CERTAIN MARRIED INDIVIDUALS LIVING APART.—

(1) Subsection (b) of section 143 (relating to certain married individuals living apart) is amended to read as follows:

"(b) CERTAIN MARRIED INDIVIDUALS LIVING APART.—For purposes of those provisions of this title which refer to this subsection, if—

"(1) an individual who is married (within the meaning of subsection (a)) and who files a separate return maintains as his home a household which constitutes for more than one-half of the taxable year the principal place of abode of a child (within the meaning of section 151(e)(3)) with respect to whom such individual is entitled to a deduction for the taxable year under section 151 (or would be so entitled but for paragraph (2) or (4) of section 152(e)), "(2) such individual furnishes over one-half of the cost of maintaining such household during the taxable year, and

"(3) during the last 6 months of the taxable year, such individual's spouse is not a member of such household,

such individual shall not be considered as married."

(2) Subparagraph (A) of section 2(b)(1) (defining head of household) is amended—

(A) by striking out "which constitutes for such taxable year" and inserting in lieu thereof "which constitutes for more than one-half of such taxable year", and

(B) by striking out "under section 151" in clause (i) and inserting in lieu thereof "under section 151 (or would be so entitled but for paragraph (2) or (4) of section 152(e))".

(3) Clause (i) of section 43(c)(1)(A) (defining eligible individual) is amended by inserting after "section 151(e)(3))" the following: "or would be so entitled but for paragraph (2) or (4) of section 152(e)".

(4) Paragraph (5) of section 44A(f) (relating to special dependency test in case of divorced parents, etc.) is amended to read as follows:

"(5) SPECIAL DEPENDENCY TEST IN CASE OF DIVORCED PARENTS, ETC.—If—

"(A) paragraph (2) or (4) of section 152(e) applies to any child with respect to any calendar year, and

"(B) such child is under the age of 15 or is physically or mentally incapable of caring for himself,

in the case of any taxable year beginning in such calendar year, such child shall be treated as a qualifying individual described in subparagraph (A) or (B) of subsection (c)(1) (whichever is appropriate) with respect to the custodial parent (within the meaning of section 152(e)(1)), and shall not be treated as a qualifying individual with respect to the noncustodial parent."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

SEC. 205. INNOCENT SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.

(a) GENERAL RULE.—Subsection (e) of section 6013 (relating to spouse relieved of liability in certain cases) is amended to read as follows:

"(e) SPOUSE RELIEVED OF LIABILITY IN CERTAIN CASES.—

"(1) IN GENERAL.—Under regulations prescribed by the Secretary, if—

"(A) a joint return has been made under this section for a taxable year,

"(B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,

"(C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and

"(D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,

then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

"(2) GROSSLY ERRONEOUS ITEMS.—For purposes of this subsection, the term 'grossly erroneous items' means, with respect to any spouse—

"(A) any item of gross income attributable to such spouse which is omitted from gross income, and

"(B) any claim of a deduction or credit by such spouse in an amount for which there is no basis in fact or law.

"(3) SUBSTANTIAL UNDERSTATEMENT.—For purposes of this subsection, the term 'substantial understatement' means any understatement (as defined in section 6661(b)(2)(A)) which exceeds the lesser of—

"(A) 10 percent of the tax required to be shown on the return for the taxable year, or

"(B) $500.

"(4) SPECIAL RULE.—For purposes of paragraph (2)(A), the determination of the spouse to whom items of gross income (other than gross income from property) are attributable shall be made without regard to community property laws."

(b) TREATMENT OF COMMUNITY INCOME.—Section 66 (relating to treatment of community income where spouses live apart) is amended by redesignating subsection (b) as subsection (c) and by inserting after subsection (a) the following new subsection:

"(b) SPOUSE RELIEVED OF LIABILITY IN CERTAIN OTHER CASES.—Under regulations prescribed by the Secretary, if—

"(1) an individual does not file a joint return for any taxable year,

"(2) such individual does not include in gross income for such taxable year an item of community income properly includible therein which, in accordance with the rules contained in section 879(a), would be treated as the income of the other spouse,

"(3) the individual establishes that he or she did not know of, and had no reason to know of, such item of community income, and

"(4) taking into account all facts and circumstances, it is inequitable to include such item of community income in such individual's gross income,

then, for purposes of this title, such items of community income shall be included in the gross income of the other spouse (and not in the gross income of the individual)."

(c) EFFECTIVE DATE.—The amendments made by subsections (a) and (b) shall apply to all taxable years to which the Internal Revenue Code of 1954 applies. Corresponding provisions shall be deemed to be included in the Internal Revenue Code of 1939 and shall apply to all taxable years to which such Code applies.

SEC. 206. DEDUCTION ALLOWED AGAINST ESTATE TAX FOR TRANSFERS SATISFYING SECTION 2516.

(a) In General.—Subsection (b) of section 2043 (relating to transfers for insufficient consideration) is amended to read as follows:

"(b) Marital Rights Not Treated as Consideration.—

"(1) In general.—For purposes of this chapter, a relinquishment or promised relinquishment of dower or curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration 'in money or money's worth'.

"(2) Exception.—For purposes of section 2053 (relating to expenses, indebtedness, and taxes), a transfer of property which satisfies the requirements of paragraph (1) of section 2516 (relating to certain property settlements) shall be considered to be made for an adequate and full consideration in money or money's worth."

(b) Cross Reference.—Subsection (e) of section 2053 (relating to deduction for expenses, indebtedness, and taxes) is amended to read as follows:

"(e) Marital Rights.—

"For provisions treating certain relinquishments of marital rights as consideration in money or money's worth, see section 2043(b)(2)."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to estates of decedents dying after the date of the enactment of this Act.

TITLE III—REVISION OF AT-RISK RULES FOR THE INVESTMENT TAX CREDIT

SEC. 301. REVISION OF AT-RISK RULES.

(a) IN GENERAL.—So much of paragraph (8) of section 46(c) (relating to limitation to amount at risk) as precedes subparagraph (F) thereof is amended to read as follows:

"(8) CERTAIN NONRECOURSE FINANCING EXCLUDED FROM CREDIT BASE.—

"(A) LIMITATION.—The credit base of any property to which this paragraph applies shall be reduced by the nonqualified nonrecourse financing with respect to such property (as of the close of the taxable year in which placed in service).

"(B) PROPERTY TO WHICH PARAGRAPH APPLIES.—This paragraph applies to any property which—

"(i) is placed in service during the taxable year by a taxpayer described in section 465(a)(1), and "(ii) is used in connection with an activity with respect to which any loss is subject to limitation under section 465.

"(C) CREDIT BASE DEFINED.—For purposes of this paragraph, the term 'credit base' means—

"(i) in the case of new section 38 property, the basis of the property, or

"(ii) in the case of used section 38 property, the cost of such property.

"(D) NONQUALIFIED NONRECOURSE FINANCING.—

"(i) IN GENERAL.—For purposes of this paragraph and paragraph (9), the term 'nonqualified nonrecourse financing' means any nonrecourse financing which is not qualified commercial financing.

"(ii) QUALIFIED COMMERCIAL FINANCING.—For purposes of this paragraph, the term 'qualified commercial financing' means any financing with respect to any property if—

"(I) such property is acquired by the taxpayer from a person who is not a related person, "(II) the amount of the nonrecourse financing with respect to such property does not exceed 80 percent of the credit base of such property, and

"(III) such financing is borrowed from a qualified person or represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government.

Such term shall not include any convertible debt.

"(iii) NONRECOURSE FINANCING.—For purposes of this subparagraph, the term 'nonrecourse financing' includes—

"(I) any amount with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar arrangements, and

"(II) except to the extent provided in regulations, any amount borrowed from a person who has an interest (other than as a creditor) in the activity in which the property is used or from a related person to such a person.

"(iv) QUALIFIED PERSON.—For purposes of this paragraph, the term 'qualified person' means any person which is actively and regularly engaged in the business of lending money and which is not—

"(I) a related person with respect to the taxpayer,

"(II) a person from which the taxpayer acquired the property (or a related person to such person), or

"(III) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).

"(v) RELATED PERSON.—For purposes of clause (i), the term 'related person' has the meaning given such term by section 168(e)(4). Except as otherwise provided in regulations prescribed by the Secretary, the determination of whether a person is a related person shall be made as of the close of the taxable year in which the property is placed in service.

"(E) APPLICATION TO PARTNERSHIPS AND S CORPORATIONS.—For purposes of this paragraph and paragraph (9)—

"(i) IN GENERAL.—Except as otherwise provided in this subparagraph, in the case of any partnership or S corporation, the determination of whether a partner's or shareholder's allocable share of any financing is nonqualified nonrecourse financing shall be made at the partner or shareholder level.

"(ii) SPECIAL RULE FOR CERTAIN RECOURSE FINANCING OF S CORPORATION.—A shareholder of an S corporation shall be treated as liable for his allocable share of any financing provided by a qualified person to such corporation if—

"(I) such financing is recourse financing (determined at the corporate level), and

"(II) such financing is provided with respect to qualified business property of such corporation.

"(iii) QUALIFIED BUSINESS PROPERTY.—For purposes of clause (ii), the term 'qualified business property' means any property if—

"(I) such property is used by the corporation in the active conduct of a trade or business, and

"(II) during the entire taxable year, such corporation had at least 3 full-time employees substantially all the services of whom were services directly related to such trade or business.

Such term shall not include any master sound recording or other tangible or intangible asset associated with literary, artistic, or musical properties.

"(iv) DETERMINATION OF ALLOCABLE SHARE.—The determination of any partner's or shareholder's allocable share of any financing shall be made in the same manner as the credit allowable by section 38 with respect to such property."

(b) TREATMENT OF SUBSEQUENT INCREASES AND DECREASES IN NONQUALIFIED NONRECOURSE FINANCING.—

(1) SUBSEQUENT DECREASES.—Paragraph (9) of section 46(c) (relating to subsequent increases in the

taxpayer's amount at risk with respect to the property) is amended to read as follows:

"(9) SUBSEQUENT DECREASES IN NONQUALIFIED NONRECOURSE FINANCING WITH RESPECT TO THE PROPERTY.—

"(A) IN GENERAL.—If, at the close of a taxable year following the taxable year in which the property was placed in service, there is a net decrease in the amount of nonqualified nonrecourse financing with respect to such property, such net decrease shall be taken into account as additional qualified investment in such property in accordance with subparagraph (C).

"(B) CERTAIN TRANSACTIONS NOT TAKEN INTO ACCOUNT.—For purposes of this paragraph, nonqualified nonrecourse financing shall not be treated as decreased through the surrender or other use of property financed by nonqualified nonrecourse financing.

"(C) MANNER IN WHICH TAKEN INTO ACCOUNT.—

"(i) CREDIT DETERMINED BY REFERENCE TO TAXABLE YEAR PROPERTY PLACED IN SERVICE.—For purposes of determining the amount of credit allowable under section 38 and the amount of credit subject to the early disposition rules under section 47, any increase in a taxpayer's qualified investment in property by reason of this paragraph shall be deemed to be additional qualified investment made by the taxpayer in the year in which the property referred to in subparagraph (A) was first placed in service.

"(ii) CREDIT ALLOWED FOR YEAR OF DECREASE IN NONQUALIFIED NONRECOURSE FINANCING.—Any credit allowable under this subpart for any increase in qualified investment by reason of this paragraph shall be treated as earned during the taxable year of the decrease in the amount of nonqualified nonrecourse financing."

(2) SUBSEQUENT INCREASES.—So much of subsection (d) of section 47 (relating to property ceasing to be at risk) as precedes paragraph (3) thereof is amended to read as follows:

"(d) INCREASES IN NONQUALIFIED NONRECOURSE FINANCING.—

"(1) IN GENERAL.—If, as of the close of the taxable year, there is a net increase with respect to the taxpayer in the amount of nonqualified nonrecourse financing (within the meaning of section 46(c)(8)) with respect to any property to which section 46(c)(8) applied, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in credits allowed under section 38 for all prior taxable years which would have resulted from reducing the qualified investment taken into account with respect to such property by the amount of such net increase.

"(2) TRANSFERS OF DEBT MORE THAN 1 YEAR AFTER INITIAL BORROWING NOT TREATED AS INCREASING NONQUALIFIED NONRECOURSE FINANCING.—For purposes of paragraph (1), the amount of nonqualified nonrecourse financing (within the meaning of section 46(c)(8)(D)) with respect to the taxpayer shall not be treated as increased by reason of a transfer of (or agreement to transfer) any evidence of an indebtedness if such transfer occurs (or such agreement is entered into) more than 1 year after the date such indebtedness was incurred."

(c) TECHNICAL AMENDMENTS.—

(1) Clause (i) of section 46(c)(8)(F) (relating to special rule for certain energy property) is amended to read as follows:

"(i) IN GENERAL.—Subparagraph (A) shall not apply with respect to qualified energy property."

(2) Subclause (III) of section 46(c)(8)(F)(ii) (defining qualified energy property) is amended to read as follows:

"(III) as of the close of the taxable year in which the property is placed in service, not more than 75 percent of the basis of such property is attributable to nonqualified nonrecourse financing, and".

(3) Subclause (IV) of section 46(c)(8)(F)(ii) is amended by striking out "nonrecourse financing (other than financing described in section 46(c)(8)(B)(ii))" and inserting in lieu thereof "nonqualified nonrecourse financing".

(4) Subparagraph (A) of section 47(d)(3) is amended by striking out "ceasing to be at risk" and inserting in lieu thereof "increasing the amount of nonqualified nonrecourse financing (within the meaning of section 46(c)(8))".

(5) Clause (i) of section 47(d)(3)(B) is amended by striking out "other than a loan described in section 46(c)(8)(B)(ii)".

(d) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to property placed in service after the date of the enactment of this Act in taxable years ending after such date; except that such amendments shall not apply to any property to which the amendments made by section 211(f) of the Economic Recovery Tax Act of 1981 do not apply.

(2) AMENDMENTS MAY BE ELECTED RETROACTIVELY.—At the election of the taxpayer, the amendments made by this section shall apply as if included in the amendments made by section 211(f) of the Economic Recovery Tax Act of 1981. Any election made under the preceding sentence shall apply to all property of the taxpayer to which the amendments made by such section 211(f) apply.

TITLE IV—ESTATE TAX PROVISIONS

SEC. 401. PERMANENT RULES FOR REFORMING GOVERNING INSTRUMENTS CREATING CHARITABLE REMAINDER TRUSTS AND OTHER CHARITABLE INTERESTS.

(a) GENERAL RULE.—Paragraph (3) of section 2055(e) (relating to disallowance of deductions in certain cases) is amended to read as follows:

"(3) REFORMATIONS TO COMPLY WITH PARAGRAPH (2).—

"(A) IN GENERAL.—A deduction shall be allowed under subsection (a) in respect of any qualified reformation.

"(B) QUALIFIED REFORMATION.—For purposes of this paragraph, the term 'qualified reformation' means a change of a governing instrument by reformation, amendment, construction, or otherwise which changes a reformable interest into a qualified interest but only if—

"(i) any difference between—

"(I) the actuarial value (determined as of the date of the decedent's death) of the qualified interest, and

"(II) the actuarial value (as so determined) of the reformable interest,

does not exceed 5 percent of the actuarial value (as so determined) of the reformable interest, and

"(ii) in the case of—

"(I) a charitable remainder interest, the noncharitable interest (before and after the qualified reformation) terminated at the same time, or

"(II) any other interest, the reformable interest and the qualified interest are for the same period.

A noncharitable interest (before reformation) for a term of years in excess of 20 years shall be treated as satisfying subclause (I) if such interest (after reformation) is for a term of 20 years.

"(C) REFORMABLE INTEREST.—For purposes of this paragraph—

"(i) IN GENERAL.—The term 'reformable interest' means any interest for which a deduction would be allowable under subsection (a) at the time of the decedent's death but for paragraph (2).

"(ii) CHARITY'S INTEREST CANNOT BE INVADED.—The term 'reformable interest' does not include any interest unless, before the remainder vests in possession, all payments to persons other than an organization described in subsection (a) are expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property.

"(iii) SPECIAL RULE FOR WILL EXECUTED BEFORE JANUARY 1, 1979, ETC.—

In the case of any interest passing under a will executed before January 1, 1979, or under a trust created before such date, clause (ii) shall not apply.

"(D) QUALIFIED INTEREST.—For purposes of this paragraph, the term 'qualified interest' means an interest for which a deduction is allowable under subsection (a).

"(E) LIMITATION.—The deduction referred to in subparagraph (A) shall not exceed the amount of the deduction which would have been allowable for the reformable interest but for paragraph (2).

"(F) SPECIAL RULE WHERE INCOME BENEFICIARY DIES.—If (by reason of the death of any individual) by the due date for filing the estate tax return (including any extension thereof) a reformable interest is in a wholly charitable trust or passes directly to a person or for a use described in subsection (a), a deduction shall be allowed for such reformable interest as if it had met the requirements of paragraph (2) on the date of the decedent's death. For purposes of the preceding sentence, the term 'wholly charitable trust' means a charitable trust which, upon the allowance of a deduction, would be described in section 4947(a)(1).

"(G) STATUTE OF LIMITATIONS.—The period for assessing any deficiency of any tax attributable to the application of this paragraph shall not expire before the date 1 year after the date on which the Secretary is notified that such reformation has occurred.

"(H) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this paragraph, including regulations providing such adjustments in the application of the provisions of section 508 (relating to special rules relating to section 501(c)(3) organizations), subchapter J (relating to estates, trusts, beneficiaries, and decedents), and chapter 42 (relating to private foundations) as may be necessary by reason of the qualified reformation."

(b) INCOME TAX DEDUCTION.—Subsection (f) of section 170 (relating to disallowance of deduction in certain cases and special rules) is amended by adding at the end thereof the following new paragraph:

"(7) REFORMATIONS TO COMPLY WITH PARAGRAPH (2).—

"(A) IN GENERAL.—A deduction shall be allowed under subsection (a) in respect to any qualified reformation.

"(B) RULES SIMILAR TO SECTION 2055 (e)(3) TO APPLY.—For purposes of this paragraph, rules similar to the rules of section 2055(e)(3) shall apply."

(c) GIFT TAX DEDUCTION.—Subsection (c) of section 2522 is amended by adding at the end thereof the following new paragraph:

"(3) REFORMATIONS TO COMPLY WITH PARAGRAPH (2).—

"(A) IN GENERAL.—A deduction shall be allowed under subsection (a) in respect to any qualified reformation.

"(B) RULES SIMILAR TO SECTION 2055(e)(3) TO APPLY.—For purposes of this paragraph, rules similar to the rules of section 2055(e)(3) shall apply."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to reformations after December 31, 1981, except that such amendments shall not apply to any reformation to which section 2055(e)(3) of the Internal Revenue Code of 1954 (as in effect on the day before the date of the enactment of this Act) applies.

SEC. 402. ALTERNATE VALUATION ELECTION AVAILABLE ONLY WHERE IT RESULTS IN REDUCTION OF GROSS ESTATE AND ESTATE TAX.

(a) GENERAL RULE.—Section 2032 (relating to alternate valuation) is amended by redesignating subsection (c) as subsection (d) and by inserting after subsection (b) the following new subsection:

"(c) ELECTION MUST DECREASE GROSS ESTATE AND ESTATE TAX.—No election may be made under this section with respect to an estate unless such election will decrease—

"(1) the value of the gross estate, and

"(2) the amount of the tax imposed by this chapter (reduced by credits allowable against such tax)."

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

SEC. 403. ALTERNATE VALUATION ELECTION AVAILABLE ON LATE RETURN.

(a) GENERAL RULE.—Subsection (d) of section 2030 (relating to time of election), as amended by section 402, is amended to read as follows:

"(d) ELECTION.—The election provided for in this section shall be made by the executor on the return of the tax imposed by this chapter. Such an election, once made, shall be irrevocable."

(b) Effective Date.—The amendment made by subsection (a) shall apply with respect to the estates of decedents dying after the date of the enactment of this Act.

TITLE V—FOREIGN TAX PROVISIONS

SEC. 501. DEFINITION OF RESIDENT ALIEN AND NONRESIDENT ALIEN.

(a) General Rule.—Section 7701 (relating to definitions) is amended by redesignating subsections (b), (c), and (d) as subsections (c), (d), and (e), respectively, and by inserting after subsection (a) the following new subsection:

"(b) Definition of Resident Alien and Nonresident Alien.—

"(1) In general.—For purposes of this title (other than subtitle B)—

"(A) Resident alien.—An alien individual shall be treated as a resident of the United States with respect to any calendar year if (and only if) such individual meets the requirements of clause (i), (ii), or (iii):

"(i) Lawfully admitted for permanent residence.—Such individual is a lawful permanent resident of the United States at any time during such calendar year.

"(ii) IMMIGRANT VISA APPLIED FOR PLUS 60-DAY PRESENCE.—An application for an immigrant visa for such individual was pending at any time during such calendar year and such individual was present in the United States on at least 60 days during such calendar year.

"(iii) SUBSTANTIAL PRESENCE TEST.—Such individual meets the substantial presence test of paragraph (2).

"(B) NONRESIDENT ALIEN.—An individual is a nonresident alien if such individual is neither a citizen of the United States nor a resident of the United States (within the meaning of subparagraph (A)).

"(2) SUBSTANTIAL PRESENCE TEST.—

"(A) IN GENERAL.—Except as provided in subparagraphs (B) and (C), an individual meets the substantial presence test of this paragraph with respect to any calendar year (hereinafter in this subsection referred to as the 'current year') if the sum of the number of days on which such individual was present in the United States during the current year and the 2 preceding calendar years (when multiplied by the applicable multiplier determined under the following table) equals or exceeds 183 days:

"In the case of days in:	The applicable multiplier is:
Current year	1
1st preceding year	⅔
2nd preceding year	⅓

"(B) EXCEPTION WHERE INDIVIDUAL IS PRESENT IN THE UNITED STATES DURING LESS THAN ONE-HALF OF CURRENT YEAR AND CLOSER CONNECTION TO FOREIGN COUNTRY IS ESTABLISHED.—An individual shall not be treated as meeting the substantial presence test of this paragraph with respect to any current year if—

"(i) such individual is present in the United States on fewer than 183 days during the current year, and

"(ii) it is established that for the current year such individual has a tax home (as defined in section 911(d)(3)) in a foreign country and has a closer connection to such foreign country than to the United States.

"(C) EXCEPTION FOR EXEMPT INDIVIDUALS.—An individual shall not be treated as meeting the substantial presence test of this paragraph with respect to any current year if such individual is an exempt individual for such year.

"(3) EXEMPT INDIVIDUAL DEFINED.—For purposes of this subsection.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), an individual is an exempt individual for the current year if, for that portion of the year during which such individual is present in the United States, such individual is—

"(i) a foreign government-related individual,

"(ii) a teacher or trainee, or

"(iii) a student.

"(B) FACTS AND CIRCUMSTANCES INDICATE INTENT TO PERMANENTLY RESIDE IN THE UNITED STATES.—An individual shall not be treated as an exempt individual if the facts and circumstances indicate that such individual intends to permanently reside in the United States.

"(C) FOREIGN GOVERNMENT-RELATED INDIVIDUAL.—The term 'foreign government-related individual' means any individual temporarily admitted into the United States by reason of—

"(i) diplomatic status, or a visa which the Secretary (after consultation with the Secretary of State) determines represents full-time diplomatic or consular status for purposes of this subsection,

"(ii) being a full-time employee of an international organization, or

"(iii) being a member of the immediate family of an individual described in clause (i) or (ii).

"(D) TEACHER OR TRAINEE.—The term 'teacher or trainee' means any individual—

"(i) who is temporarily admitted into the United States under subparagraph (J) of section 101(15) of the Immigration and Nationality Act (other than as a student), and

"(ii) who substantially complies with the requirements for being so admitted.

"(E) STUDENT.—The term 'student' means any individual—

"(i) who is temporarily admitted into the United States—

"(I) under subparagraph (F) of section 101(15) of the Immigration and Nationality Act, or

"(II) as a student under subparagraph (J) of such section 101(15), and "(ii) who substantially complies with the requirements for being so admitted.

"(F) SPECIAL RULES FOR TEACHERS, TRAINEES, AND STUDENTS.—

"(i) LIMITATION ON TEACHERS AND TRAINEES.—An individual shall not be treated as an exempt individual by reason of clause (ii) of subparagraph (A) for the current year if, for any 2 calendar years during the preceding 6 calendar years, such person was an exempt person under clause (ii) or (iii) of subparagraph (A).

"(ii) LIMITATION ON STUDENTS.—For any calendear year after the 5th calendar year for which an individual was an exempt individual under clause (ii) or (iii) of subparagraph (A), such individual shall not be treated as an exempt individual by reason of clause (iii) of subparagraph (A), unless such individual establishes to the satisfaction of the Secretary that such individual does not intend to permanently reside in the United States and that such individual meets the requirements of subparagraph (E)(ii).

"(4) LAWFUL PERMANENT RESIDENT.—For purposes of this subsection, an individual is a lawful permanent resident of the United States at any time if—

"(A) such individual has the status of having been lawfully accorded the privilege of residing permanently in the United States as an immigrant in accordance with the immigration laws, and

"(B) such status has not been revoked.

"(5) IMMIGRANT VISA.—For purposes of this subsection, the term 'immigrant visa' means any visa entitling an individual to be lawfully admitted into the United States for permanent residence.

"(6) PRESENCE IN THE UNITED STATES.—For purposes of this subsection—

"(A) IN GENERAL.—Except as provided in subparagraph (B), an individual shall be treated as present in the United States on any day if such individual is physically present in the United States at any time during such day.

"(B) COMMUTERS FROM CANADA OR MEXICO.—If an individual regularly commutes to employment (or self-employment) in the United States from a place of residence in Canada or Mexico, such individual shall not be treated as present in the United States on any day during which he so commutes.

"(7) ANNUAL STATEMENTS.—The Secretary may prescribe regulations under which an individual who (but for subparagraph (B) or (C) of paragraph (2)) would meet the 183-day presence test of paragraph (2) is required to submit an annual statement setting forth the basis on which such individual claims the benefits of subparagraph (B) or (C) of paragraph (2), as the case may be.

"(8) TAXABLE YEAR.—

"(A) IN GENERAL.—For purposes of this title, an alien individual who has not established a taxable year for any prior period shall be treated as having a taxable year which is the calendar year.

"(B) FISCAL YEAR TAXPAYER.—If—

"(i) an individual is treated under paragraph (1) as a resident of the United States for any calendar year, and

"(ii) after the application of subparagraph (A), such individual has a taxable year other than a calendar year, he shall be treated as a resident of the United States with respect to any portion of a taxable year which is within such calendar year."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1983.

SEC. 502. TREATMENT OF COMMUNITY INCOME.

(a) GENERAL RULE.—Subsection (a) of section 879 (relating to tax treatment of certain community income in the case of a resident or citizen of the United States who is married to a nonresident alien individual) is amended by striking out so much of such subsection as precedes paragraph (1) thereof and inserting in lieu thereof the following:

"(a) GENERAL RULE.—In the case of a married couple 1 or both of whom are nonresident alien individuals and who have community income for the taxable year, such community income shall be treated as follows:".

(b) CLERICAL AMENDMENTS.—

(1) The heading of section 879 is amended to read as follows:

"SEC. 879. TAX TREATMENT OF CERTAIN COMMUNITY INCOME IN THE CASE OF NONRESIDENT ALIEN INDIVIDUALS."

(2) The table of sections for subpart A of part II of subchapter N of chapter 1 is amended by striking

out the item relating to section 879 and inserting in lieu thereof the following:

"Sec. 879. Tax treatment of certain community income in the case of nonresident alien individuals."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

SEC. 503. AMENDMENTS RELATED TO FOREIGN PERSONAL HOLDING COMPANIES

(a) ATTRIBUTION FROM FAMILY MEMBERS.—Subsection (a) of section 554 (relating to constructive ownership) is amended by adding at the end thereof the following new sentence:

"For purposes of the stock ownership requirement provided in section 552(a)(2), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered by reason of so much of paragraph (2) as relates to attribution through family membership as owned by a citizen or by a resident alien individual who is not the spouse of the nonresident individual."

(b) INCLUSION IN INCOME OF UNITED STATES PERSONS HOLDING INTEREST THROUGH FOREIGN ENTITY.—Section 551 (relating to foreign personal holding company income taxed to United States shareholders) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) STOCK HELD THROUGH FOREIGN ENTITY.—For purposes of this section, stock of a foreign personal holding company owned (directly or through the application of this subsection) by—

"(1) a partnership, estate, or trust which is not a United States shareholder, or

"(2) a foreign corporation which is not a foreign personal holding company,

shall be considered as being owned proportionately by its partners, beneficiaries, or shareholders. In any case to which the preceding sentence applies, the Secretary may by regulations provide for such adjustments in the application of this part as may be necessary to carry out the purposes of the preceding sentence."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 1983.

SEC. 504. AMENDMENTS RELATED TO SECTION 1248.

(a) ELIMINATION OF DOUBLE TAXATION OF EARNINGS AND PROFITS OF CERTAIN FOREIGN CORPORATIONS.—

(1) Section 959 (relating to exclusion from gross income of previously taxed earnings and profits) is amended by adding at the end thereof the following new subsection:

"(e) COORDINATION WITH AMOUNTS PREVIOUSLY TAXED UNDER SECTION 1248.—For purposes of this section and section 960(b), any amount included in the gross income of any person as a dividend by reason of subsection (a) or (f) of section 1248 shall be treated as an amount included in the gross income of such person under section 951(a)(1)(A)."

(2) Section 1248 is amended by adding at the end thereof the following new subsection:

"(i) CROSS REFERENCE.—

"For provision excluding amounts previously taxed under this section from gross income when subsequently distributed, see section 959(e)."

(b) CLARIFICATION OF SECTION 1248(c)(2)(D).—Subparagraph (D) of section 1248(c)(2) (relating to earnings and profits of subsidiaries of foreign corporations) is amended by striking out "section 958(a)(2)" and inserting in lieu thereof "section 958(a)".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to transactions to which subsection (a) or (f) of section 1248 of the Internal Revenue Code of 1954 applies occurring after the date of the enactment of this Act.

SEC 505. COORDINATION OF SUBPART F WITH FOREIGN PERSONAL HOLDING COMPANY PROVISIONS.

(a) GENERAL RULE.—Subsection (d) of section 951 (relating to coordination with foreign personal holding company provisions) is amended to read as follows:

"(d) COORDINATION WITH FOREIGN PERSONAL HOLDING COMPANY PROVISIONS.—If, but for this subsection, an amount would be included in the gross income of a United States shareholder for any taxable year both under subsection (a)(1)(A)(i) and under section 551(b) (relating to foreign personal holding company income included in gross income of United States shareholder), such amount shall be included in the gross income of such shareholder only under subsection (a)(1)(A)."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years of United States shareholders beginning after the date of the enactment of this Act.

SEC. 506. STAPLED STOCK; STAPLED ENTITIES.

(a) GENERAL RULE.—Part IX of subchapter B of chapter 1 is amended by inserting after section 269A the following new section:

"SEC 269B. STAPLED ENTITIES.

"(a) GENERAL RULE.—Except as otherwise provided by regulations, for purposes of this title—

"(1) if a domestic corporation and a foreign corporation are stapled entities, the foreign corporation shall be treated as a domestic corporation.

"(2) in applying section 1563, stock in a second corporation which constitutes a stapled interest with respect to stock of a first corporation shall be treated as owned by such first corporation, and

"(3) in applying subchapter M for purposes of determining whether any stapled entity is a regulated investment company or a real estate investment trust, all entities which are stapled entities with respect to each other shall be treated as 1 entity.

"(b) SECRETARY TO PRESCRIBE REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to prevent avoidance or evasion of Federal income tax through the use of stapled entities. Such regulations may include (but shall not be limited to) regulations providing the extent to which 1 of such entities shall be treated as owning the other entity (to the extent of the stapled interest).

"(c) DEFINITIONS.—For purposes of this section—

"(1) ENTITY.—The term 'entity' means any corporation, partnership, trust, association, estate, or other form of carrying on a business or activity.

"(2) STAPLED ENTITIES.—The term 'stapled entities' means any group of 2 or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of stapled interests.

"(3) STAPLED INTERESTS.—Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of 1 of such interests the other such interests are also transferred or required to be transferred."

(b) CLERICAL AMENDMENT.—The table of sections for part IX of subchapter B of chapter 1 is amended by inserting after the item relating to section 269A the following new item:

"Sec. 269B. Stapled entities."

(c) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall take effect on the date of the enactment of this Act.

(2) INTERESTS STAPLED AS OF JUNE 30, 1983.—In the case of any interests which on June 30, 1983, were stapled interests (as defined in section 269B(c)(3) of the Internal Revenue Code of 1954, as added by this section), the amendments made by this section shall take effect on Janaury 1, 1985.

TITLE VI—MISCELLANEOUS TREASURY ADMINISTRATIVE PROVISIONS

SEC. 601. SIMPLIFICATION OF CERTAIN REPORTING REQUIREMENTS.

(a) DISC REPORT.—

(1) Section 506 of the Revenue Act of 1971 (relating to submission of annual reports to Congress) is amended to read as follows:

"SEC. 506. SUBMISSION OF REPORTS TO CONGRESS.

"The Secretary of the Treasury shall, for the calendar year 1981 and each second calendar year thereafter, submit a report to the Congress within 27½ months following the close of such calendar year setting forth an analysis of the operation and effect of the provisions of this title."

(2) The amendment made by paragraph (1) shall apply to reports for calendar years after 1980.

(b) REPORT ON POSSESSIONS CORPORATIONS.—The Secretary of the Treasury shall, for the calendar year 1981 and each second calendar year thereafter, submit a report to the Congress within 18 months following the close of such calendar year setting forth an analysis of the operation and effect of sections 936 and 934(b) of the Internal Revenue Code of 1954.

(c) HIGH INCOME TAXPAYER REPORT.—

(1) Section 2123 of the Tax Reform Act of 1976 is amended to read as follows:

"SEC. 2123. HIGH INCOME TAXPAYER REPORT.

"The Secretary of the Treasury shall publish annually information on the amount of tax paid by individual taxpayers with high total incomes. Total income for this purpose is to be calculated and set forth by adding to adjusted gross income any items of tax preference excluded from, or deducted in arriving at, adjusted gross income, and by subtracting any investment expenses incurred in the production of such income to the extent of the investment income. These data are to include the number of such individuals with total income over $200,000 who owe no Federal income tax (after credits) and the deductions, exclusions, or credits used by them to avoid tax."

(2) The amendment made by paragraph (1) shall apply to information published after the date of the enactment of this Act.

(d) INTERNATIONAL BOYCOTT REPORTS.—

(1) Section 1067 of the Tax Reform Act of 1976 is amended to read as follows:

"SEC. 1067. REPORTS BY THE SECRETARY.

"(a) GENERAL RULE.—As soon after the close of each 4-year period as the data become available, the Secretary shall transmit a report to the Committee on Ways and Means of the House of Representatives and to the Committee on Finance of the Senate setting forth for such 4-year period—

"(1) the number of reports filed under section 999(a) of the Internal Revenue Code of 1954 for taxable years ending with or within each calendar year in such 4-year period,

"(2) the number of such reports with respect to each such calendar year on which the taxpayer indicated international boycott participation or cooperation (within the meaning of section 999(b)(3) of such Code), and

"(3) a detailed description of the manner in which the provisions of such Code relating to international boycott activity have been administered during such 4-year period.

"(b) 4-YEAR PERIOD.—For purposes of subsection (a), the term '4-year period' means the period consisting of 4 calendar years beginning with calendar year 1983 and each subsequent fourth calendar year."

(2) The amendment made by paragraph (1) shall apply to reports for periods after December 31, 1982.

SEC. 602. REMOVAL OF $1,000,000 LIMITATION ON WORKING CAPITAL FUND.

The last sentence of section 322(a) of title 31, United States Code (placing a $1,000,000 limitation on the working capital fund for the Department of the Treasury), is hereby repealed.

SEC. 603. INCREASE IN LIMITATION ON REVOLVING FUND FOR REDEMPTION OF REAL PROPERTY.

Subsection (a) of section 7810 (relating to revolving fund for redemption of real property) is amended by striking out "$1,000,000" and inserting in lieu thereof "$10,000,000".

SEC. 604. SECRETARY OF THE TREASURY AUTHORIZED TO ACCEPT GIFTS AND BEQUESTS.

Section 321 of title 31, United States Code, is amended by adding at the end thereof the following new subsection:

"(d)(1) The Secretary of the Treasury may accept, hold, administer, and use gifts and bequests of property, both real and personal, for the purpose of aiding or facilitating the work of the Department of the Treasury. Gifts and bequests of money and the proceeds from sales of other property received as gifts or bequests shall be deposited in the Treasury in a separate fund and shall be disbursed on order of the Secretary of the Treasury. Property accepted under this paragraph, and the proceeds thereof, shall be used as nearly as possible in accordance with the terms of the gift or bequest.

"(2) For purposes of the Federal income, estate, and gift taxes, property accepted under paragraph (1) shall be considered as a gift or bequest to or for the use of the United States.

"(3) The Secretary of the Treasury may invest and reinvest the fund in public debt securities with maturities suitable for the needs of the fund and bearing interest at rates determined by the Secretary of the Treasury, taking into consideration the current average market yield on outstanding marketable obligations of the United States of comparable maturities. Income accruing from the securities, and from any other property accepted under paragraph (1), shall be deposited to the credit of the fund, and shall be disbursed on order of the Secretary of the Treasury for purposes as nearly as possible in accordance with the terms of the gifts or bequests."

SEC. 605. REPEAL OF STAMP REQUIREMENT FOR DISTILLED SPIRITS.

(a) General Rule.—Section 5205 (relating to stamps) is hereby repealed.

(b) Repeal of Penalties.—Section 5604 (relating to penalties relating to stamps, marks, brands, and containers) is hereby repealed.

(c) Technical Amendments.—

(1) Subsection (b) of section 5116 is amended to read as follows:

"(b) Cross Reference.—

"For provisions relating to containers of distilled spirits, see section 5206."

(2) Section 5235 is amended—

(A) by striking out "stamped," in the first sentence, and

(B) by striking out the last sentence.

(3) Subsection (b) of section 6801 is amended by striking out "taxes; except that" and all that follows down through the end thereof and inserting in lieu thereof the following: "taxes."

(d) EFFECTIVE DATE.—The amendments made by this section shall take effect on January 1, 1984.

SEC. 606. EXTENSION OF PERIOD FOR COURT REVIEW OF JEOPARDY ASSESSMENT WHERE PROMPT SERVICE NOT MADE ON SECRETARY.

(a) GENERAL RULE.—Paragraph (2) of section 7429(b) (relating to judicial review) is amended by adding at the end thereof the following new sentence:

"If the court determines that proper service was not made on the Secretary within 5 days after the date of the commencement of the action, the running of the 20-day period set forth in the preceding sentence shall not begin before the day on which proper service was made on the Secretary."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to actions commenced after the date of the enactment of this Act.

TITLE VII—TAX COURT PROVISIONS

SEC. 701. CERTIFIED PUBLIC ACCOUNTANTS AND ENROLLED AGENTS AUTHORIZED TO REPRESENT TAXPAYERS IN SMALL TAX CASES.

(a) GENERAL RULE.—Section 7463 (relating to disputes involving $5,000 or less) is amended by adding at the end thereof the following new subsection:

"(g) REPRESENTATION OF TAXPAYER.—In any case in which the proceedings are conducted under this section, any person who is—

"(1) a certified public accountant, or

"(2) an enrolled agent authorized to practice before the Internal Revenue Service,

shall be allowed to represent the taxpayer."

(b) REPRESENTATION OF PARTIES IN REGULAR CASES.—Section 7452 (relating to representation of parties before Tax Court) is amended by striking out the last sentence.

(c) EFFECTIVE DATES.—

(1) SUBSECTION (a).—The amendment made by subsection (a) shall take effect on the date of the enact-

ment of this Act. Nothing in section 7463(g) of the Internal Revenue Code of 1954 (as added by subsection (a)) shall prevent the Tax Court from extending its rules of practice relating to suspension or disqualification to persons referred to in such section 7463(g).

(2) SUBSECTION (b).—The amendment made by subsection (b) shall take effect on the date of the enactment of this Act. Such amendment shall not apply to any person admitted to practice before the Tax Court before such date of enactment.

SEC. 702. ANNUITIES TO SURVIVORS OF TAX COURT JUDGES.

(a) ENTITLEMENT TO ANNUITY.—Subsection (h) of section 7448 (relating to entitlement to annuity) is amended—

(1) by striking out "$900 per year divided by the number of such children or $360 per year," in paragraph (2) and inserting in lieu thereof "$4,644 per year divided by the number of such children or $1,548 per year,"; and

(2) by striking out "$480 per year" in paragraph (3) and inserting in lieu thereof "$5,580 per year divided by the number of such children or $1,860 per year, whichever is lesser".

(b) TECHNICAL AMENDMENT.—Subsection (s) of section 7448 (relating to increases in annuities on account of increases in pay) is amended by adding at the end thereof the following new sentence: "Nothing in this subsection shall be construed to increase any annuity payable under paragraph (2) or (3) of subsection (h) (as the case may be) to an amount in excess of the limitation contained in such paragraph."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to annuities payable with respect to months beginning after the date of the enactment of this Act.

SEC. 703. PROCEEDINGS WHICH MAY BE ASSIGNED TO COMMISSIONERS.

(a) IN GENERAL.—Subsection (d) of section 7456 (relating to proceedings which may be assigned to commissioners) is amended to read as follows:

"(d) PROCEEDINGS WHICH MAY BE ASSIGNED TO COMMISSIONERS.—The chief judge may assign—

"(1) any declaratory judgment proceeding,

"(2) any proceeding under section 7463,

"(3) any proceeding where neither the amount of the deficiency placed in dispute (within the meaning of section 7463) nor the amount of any claimed overpayment exceeds $5,000; and

"(4) any other proceeding which the chief judge may designate,

to be heard by the commissioners of the court, and the court may authorize a commissioner to make the decision of the court with respect to any proceeding described in paragraph (1), (2), or (3), subject to such conditions and review as the court may provide."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect as if enacted as part of the Miscellaneous Revenue Act of 1982.

SEC. 704. SPECIAL TRIAL JUDGES.

(a) IN GENERAL.—Subsection (a) of section 7456 (relating to administration of oaths and procurement of testimony) is amended by striking out "commissioner" each place it appears and inserting in lieu thereof "special trial judge".

(b) APPOINTMENT AND COMPENSATION.—Subsection (c) of section 7456 (relating to commissioners) is amended—

(1) by striking out "COMMISSIONERS" in the heading and inserting in lieu thereof "SPECIAL TRIAL JUDGES";

(2) by striking out "commissioners" and inserting in lieu thereof "special trial judges"; and

(3) by striking out "commissioner" and inserting in lieu thereof "special trial judge".

(c) PROCEEDINGS WHICH MAY BE ASSIGNED TO SPECIAL TRIAL JUDGES.—Subsection (d) of section 7456 (relating to proceedings which may be assigned to commissioners), as amended by section 703, is amended—

(1) by striking out "COMMISSIONERS" in the heading and inserting in lieu thereof "SPECIAL TRIAL JUDGES";

(2) by striking out "commissioners" and inserting in lieu thereof "special trial judges"; and

(3) by striking out "commissioner" and inserting in lieu thereof "special trial judge".

(d) CONFORMING AMENDMENT.—Subsection (c) of section 7471 (cross reference relating to compensation and travel and subsistence allowances of commissioners) is amended by striking out "COMMISSIONERS" in the heading and inserting in lieu thereof "SPECIAL TRIAL JUDGES", and by striking out "commissioners" and inserting in lieu thereof "special trial judges".

(e) EFFECTIVE DATE.—

(1) The amendments made by this section shall take effect on the date of the enactment of this Act.

(2) Any reference in any law to a commissioner of the Tax Court shall be treated as a reference to a special trial judge of the Tax Court.

SEC. 705. PUBLICITY OF TAX COURT PROCEEDINGS.

(a) IN GENERAL.—Section 7461 (relating to publicity of proceedings) is amended to read as follows:

"SEC. 7461. PUBLICITY OF PROCEEDINGS.

"(a) GENERAL RULE.—Except as provided in subsection (b), all reports of the Tax Court and all evidence received by the Tax Court and its divisions, including a transcript of the stenographic report of the hearings, shall be public records open to the inspection of the public.

"(b) EXCEPTIONS.—

"(1) TRADE SECRETS OR OTHER CONFIDENTIAL INFORMATION.—The Tax Court may make any provision which is necessary to prevent the disclosure of trade secrets or other confidential information including a provision that any document or information be placed under seal to be opened only as directed by the court.

"(2) EVIDENCE, ETC.—After the decision of the Tax Court in any proceeding has become final, the Tax Court may, upon motion of the taxpayer or the Secretary, permit the withdrawal by the party entitled thereto of originals of books, documents, and records, and of models, diagrams, and other exhibits, introduced in evidence before the Tax Court or any division; or the Tax Court may, on its own motion, make such other disposition thereof as it deems advisable."

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

TITLE VIII—SIMPLIFICATION OF INCOME TAX CREDITS

SEC. 801. SHORT TITLE.

This title may be cited as the "Tax Credit Simplification Act of 1983".

SEC. 802. CREDITS GROUPED TOGETHER IN MORE LOGICAL ORDER.

(a) CREDITS DIVIDED INTO 4 CATEGORIES.—The table of subparts for part IV of subchapter A of chapter 1 (relating to credits against tax) is amended to read as follows:

"Subpart A. Nonrefundable personal credits.
"Subpart B. Foreign tax credit, etc.
"Subpart C. Refundable credits.
"Subpart D. Business-related credits."

(b) EXISTING CREDITS ASSIGNED TO APPROPRIATE CATEGORY.—Part IV of subchapter A of chapter 1 is amended by striking out the heading and table of sections for subpart A and inserting in lieu thereof the following:

"Subpart A—Nonrefundable Personal Credits

"Sec. 21. Expenses for household and dependent care services necessary for gainful employment.
"Sec. 22. Credit for the elderly and the permanently and totally disabled.
"Sec. 23. Residential energy credit.
"Sec. 24. Contributions to candidates for public office.
"Sec. 25. Limitation based on tax liability; definition of tax liability.

"Subpart B—Foreign Tax Credit, Etc.

"Sec. 28. Taxes of foreign countries and possessions of the United States; possession tax credit.
"Sec. 29. Clinical testing expenses for certain drugs for rare diseases or conditions.
"Sec. 30. Credit for producing fuel from a nonconventional source.

“Subpart C—Refundable Credits

“Sec. 31. Tax withheld on wages, interest, dividends, and patronage dividends.
“Sec. 32. Earned income.
“Sec. 33. Tax withheld at source on nonresident aliens and foreign corporations.
“Sec. 34. Certain uses of gasoline and special fuels.
“Sec. 35. Overpayments of tax.

“Subpart D—Business Related Credits

“Sec. 38. General business credit.
“Sec. 39. Carryback and carry forward of unused credits.
“Sec. 40. Alcohol used as fuel.
“Sec. 41. Credit for increasing research activities.
“Sec. 42. Employee stock ownership credit.”

(c) SECTIONS MOVED TO APPROPRIATE PLACE IN PART IV.—

(1) DESIGNATION.—The following sections of such part IV are henceforth to be designated in accordance with the following table:

Old section number:	New section number:	New subpart designation:
44A	21	A
37	22	A
44C	23	A
41	24	A
33	28	B
44H	29	B
44D	30	B
31	31	C
43	32	C
32	33	C
39	34	C
45	35	C
44E	40	D
44F	41	D
44G	42	D

(2) PLACED IN APPROPRIATE SUBPARTS.—Each section for which paragraph (1) provides a new section

number is hereby moved to the appropriate place in the appropriate subpart of such part IV.

SEC. 803. UNIFORM LIMITATION ON PERSONAL NONREFUNDABLE CREDITS.

Subpart A of part IV of subchapter A of chapter 1 is amended by adding after section 24 the following new section:

"SEC. 25. LIMITATION BASED ON TAX LIABILITY; DEFINITION OF TAX LIABILITY.

"(a) LIMITATION BASED ON AMOUNT OF TAX.—The aggregate amount of credits allowed by this subpart for the taxable year shall not exceed the taxpayer's tax liability for such taxable year.

"(b) TAX LIABILITY.—For purposes of this section—

"(1) IN GENERAL.—The term 'tax liability' means the tax imposed by this chapter for the taxable year.

"(2) EXCEPTION FOR CERTAIN TAXES.—For purposes of paragraph (1), any tax imposed by any of the following provisions shall not be treated as tax imposed by this chapter:

"(A) section 56 (relating to corporate minimum tax)

"(B) subsection (m)(5)(B), (o)(2), or (q) of section 72 (relating to additional tax on certain distributions), "(C) section 402(e) (relating to tax on lump sum distributions),

"(D) section 408(f) (relating to additional tax on income from certain retirement accounts),

"(E) section 531 (relating to accumulated earnings tax),

"(F) section 541 (relating to personal holding company tax),

"(G) section 1351(d)(1) (relating to recoveries of foreign expropriation losses),

"(H) section 1374 (relating to tax on certain capital gains of S corporations), and

"(I) section 1375 (relating to tax imposed when passive investment income of corporation having subchapter C earnings and profits exceeds 25 percent of gross receipts).

"(c) SIMILAR RULE FOR ALTERNATIVE MINIMUM TAX FOR TAXPAYERS OTHER THAN CORPORATIONS.—

"For treatment of tax imposed by section 55 as not imposed by this chapter, see section 55(c)."

SEC. 804. UNIFORM CARRYOVER PROVISIONS FOR BUSINESS-RELATED CREDITS.

Subpart D of part IV of subchapter A of chapter 1 is amended by inserting before section 40 the following new sections:

"SEC. 38. GENERAL BUSINESS CREDIT.

"(a) ALLOWANCE OF CREDIT.—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the sum of—

"(1) the business credit carryforwards carried to such taxable year,

"(2) the amount of the current year business credit, plus

"(3) the business credit carrybacks carried to such taxable year.

"(b) CURRENT YEAR BUSINESS CREDIT.—For purposes of this subpart, the amount of the current year business credit is the sum of the following credits determined for the taxable year:

"(1) the investment credit determined under section 46(a),

"(2) the targeted jobs credit determined under section 51(a),

"(3) the alcohol fuels credit determined under section 40(a),

"(4) the research credit determined under section 41(a), plus

"(5) the employee stock ownership credit determined under section 42(a).

"(c) LIMITATION BASED ON AMOUNT OF TAX.—

"(1) In general.—The credit allowed under subsection (a) for any taxable year shall not exceed the sum of—

"(A) so much of the taxpayer's net tax liability for the taxable year as does not exceed $25,000, plus

"(B) 85 percent of so much of the taxpayer's net tax liability for the taxable year as exceeds $25,000.

"(2) Net tax liability.—For purposes of paragraph (1), the term 'net tax liability' means the tax liability (as defined in section 25(b)), reduced by the sum of the credits allowable under subparts A and B of this part.

"(3) Special rules.—

"(A) Married individuals.—In the case of a husband or wife who files a separate return, the amount specified under subparagraphs (A) and (B) of paragraph (1) shall be $12,500 in lieu of $25,000. This subparagraph shall not apply if the spouse of the taxpayer has no business credit carryforward or carryback to, and has no current year business credit for, the taxable year of such spouse which ends within or with the taxpayer's taxable year.

"(B) CONTROLLED GROUPS.—In the case of a controlled group, the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (1) shall be reduced for each component member of such group by apportioning $25,000 among the component members of such group in such manner as the Secretary shall by regulations prescribe. For purposes of the preceding sentence, the term 'controlled group' has the meaning given to such term by section 1563(a).

"(C) LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.—In the case of a person described in subparagraph (A) or (B) of section 46(e)(1), the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (1) shall equal such person's ratable share (as determined under section 46(e)(2)) of such amount.

"(D) ESTATES AND TRUSTS.—In the case of an estate or trust, the $25,000 amount specified under subparagraphs (A) and (B) of paragraph (1) shall be reduced to an amount which bears the same ratio to $25,000 as the portion of the income of the estate or trust which is not allocated to beneficiaries bears to the total income of the estate or trust.

"SEC. 39. CARRYBACK AND CARRYFORWARD OF UNUSED CREDITS.

"(a) IN GENERAL.—

"(1) 3 YEAR CARRYBACK AND 15 YEAR CARRYFORWARD.—If the sum of the business credit carryforwards to the taxable year plus the amount of the current year business credit for the taxable year exceeds the amount of the limitation imposed by subsection (c) of section 38 for such taxable year (hereinafter in this section referred to as the 'unused credit year'), such excess (to the extent attributable to the amount of the current year business credit) shall be—

"(A) a business credit carryback to each of the 3 taxable years preceding the unused credit year, and

"(B) a business credit carryforward to each of the 15 taxable years following the unused credit year,

and, subject to the limitations imposed by subsections (b) and (c), shall be taken into account under the provisions of section 38(a) in the manner provided in section 38(a).

"(2) AMOUNT CARRIED TO EACH YEAR.—

"(A) ENTIRE AMOUNT CARRIED TO FIRST YEAR.—The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 18 taxable years to which (by reason of paragraph (1)) such credit may be carried.

"(B) AMOUNT CARRIED TO OTHER 17 YEARS.—The amount of the unused credit for the unused credit year shall be carried to each of the other 17 taxable years to the extent that such unused credit may not be taken into account under section 38(a) for a prior taxable year because of the limitations of subsections (b) and (c).

"(b) LIMITATION ON CARRYBACKS.—The amount of the unused credit which may be taken into account under section 38(a)(3) for any preceding taxable year shall not exceed the amount by which the limitation imposed by section 38(c) for such taxable year exceeds the sum of—

"(1) the amounts determined under paragraphs (1) and (2) of section 38(a) for such taxable year, plus

"(2) the amounts which (by reason of this section) are carried back to such taxable year and are attributable to taxable years preceding the unused credit year.

"(c) LIMITATION ON CARRYFORWARDS.—The amount of the unused credit which may be taken into account under section 38(a)(1) for any succeeding taxable year shall not exceed the amount by which the limitation imposed by section 38(c) for such taxable year exceeds the sum of the amounts which, by reason of this section, are carried to such taxable year and are attributable to taxable years preceding the unused credit year.

"(d) TRANSITIONAL RULES.—

"(1) CARRYFORWARDS.—

"(A) IN GENERAL.—Any carryforward from an unused credit year under section 46, 50A, 53, 44E, 44F, or 44G which has not expired before the beginning of the first taxable year beginning after December 31, 1983, shall be aggregated with other such carryforwards from such unused credit year and shall be a business credit carryforward to each taxable year beginning after December 3, 1983, which is 1 of the first 15 taxable years after such unused credit year.

"(B) AMOUNT CARRIED FORWARD.—The amount carried forward under subparagraph (A) to any taxable year shall be properly reduced for any amount allowable as a credit with respect to such carryforward for any taxable year before the year to which it is being carried.

"(2) CARRYBACKS.—In determining the amount allowable as a credit for any taxable year beginning before January 1, 1984, as the result of the carryback of a general business tax credit from a taxable year beginning after December 31, 1983, paragraph (1) of subsection (b) shall be applied as if it read as follows:

"'(1) the sum of the credits allowable for such taxable year under sections 38, 40, 44B, 44E, 44F, and 44G, plus'."

SEC. 805. TECHNICAL AND CONFORMING AMENDMENTS.

(a) REFERENCES TO OLD AND NEW PROVISIONS.—Whenever in this section reference is made to an old or new section or other provision, the reference is to the provision before (in the case of "old") or after (in the case of "new") the changes made by section 802 of this Act.

(b) OLD SECTION 21.—

(1) REDESIGNATION.—Old section 21 (relating to effect of changes) is redesignated as section 15.

(2) CONFORMING AMENDMENTS.—Sections 441(f)(2)(A) and 6013(c) are each amended by striking out "21" and inserting in lieu thereof "15".

(3) TABLE OF SECTIONS.—The table of sections for part III of subchapter A of chapter 1 is amended by striking out the item relating to section 21 and inserting in lieu thereof the following:

"Sec. 15. Effect of changes."

(c) NEW SECTION 21.—New section 21 (relating to expenses for household and dependent care services necessary for gainful employment) is amended—

(1) by striking out subsection (b) and by redesignating subsections (c), (d), (e), (f), and (g) as subsections (b), (c), (d), (e), and (f), respectively,

(2) by striking out "subsection (c)(1)" in subsection (a) and inserting in lieu thereof "subsection (b)(1)",

(3) by striking out "subsection (c)(2)" in subsection (a) and inserting in lieu thereof "subsection (b)(2)",

(4) by striking out "subsection (c)(1)(C)" in paragraph (2) of subsection (d) (as redesignated by paragraph (1)) and inserting in lieu thereof "subsection (b)(1)(C)",

(5) by striking out "subsection (d)(1)" in subparagraph (A) of subsection (d)(2) (as redesignated by paragraph (1)) and inserting in lieu thereof, "subsection (c)(1)",

(6) by striking out "subsection (d)(2)" in subparagraph (B) of subsection (d)(2) (as redesignated by paragraph (1)) and inserting in lieu thereof "subsection (c)(2)", and

(7) by striking out "subsection (c)(1)" in paragraph (5) of subsection (e) (as redesignated by paragraph (1)) and inserting in lieu thereof "subsection (b)(1)".

(d) NEW SECTION 22.—New section 22 (relating to the credit for the elderly and the permanently and totally disabled) is amended—

(1) by striking out "section 37 amount" each place it appears in the text and inserting in lieu thereof "section 22 amount",

(2) by striking out the heading of subsection (c) and inserting in lieu thereof "(c) SECTION 22 AMOUNT.—", and

(3) by amending subsection (d) to read as follows:

"(d) ADJUSTED GROSS INCOME LIMITATION.—If the adjusted gross income of the taxpayer exceeds—

"(1) $7,500 in the case of a single individual,

"(2) $10,000 in the case of a joint return, or

"(3) $5,000 in the case of a married individual filing a separate return,

the section 22 amount shall be reduced by one-half of the excess of the adjusted gross income over $7,500, $10,000, or $5,000, as the case may be."

(e) NEW SECTION 23.—Subsection (b) of new section 23 (relating to residential energy credit) is amended by striking out paragraphs (5) and (6) and inserting in lieu thereof the following:

"(5) CARRYFORWARD OF UNUSED CREDIT.—

"(A) IN GENERAL.—If the credit allowable under subsection (a) for any taxable year exceeds the limitation imposed by section 25(a) for such taxable year reduced by the sum of the credits allowable under this subpart (other than this section), such excess shall be carried to the succeeding taxable year and added to the credit allowable under subsection (a) for such succeeding taxable year.

"(B) NO CARRYFORWARD TO TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1987.—No amount may be carried under subparagraph (A) to any taxable year beginning after December 31, 1987."

(f) NEW SECTION 24.—Subsection (b) of new section 24 (relating to contributions to candidates for political office) is amended by striking out paragraph (2) and by redesignating paragraph (3) as paragraph (2).

(g) NEW SECTION 29.—

(1) Paragraph (1) of new section 29(b) (defining qualified clinical testing expenses) is amended by striking out "section 44F" each place it appears and inserting in lieu thereof "section 41".

(2) Paragraph (1) of new section 29(c) is amended by striking out "for purposes of determining the credit

allowable under section 44F" and inserting in lieu thereof "for purposes of determining the amount of the research credit under section 41(a)".

(3) Paragraph (2) of new section 29(c) is amended—

(A) by striking out "section 44F(b)" and inserting in lieu thereof "section 41(b)", and

(B) by striking out "section 44F" and inserting in lieu thereof "section 41".

(4) Paragraph (2) of new section 29(d) is amended to read as follows:

"(2) LIMITATION BASED ON AMOUNT OF TAX.—The credit allowed by this section for any taxable year shall not exceed the taxpayer's tax liability for the taxable year (as defined in section 25(b)), reduced by the sum of the credits allowable under subpart A and section 28."

(5) Paragraph (4) of new section 29(d) is amended by striking out "section 44F(f)" and inserting in lieu thereof "section 41(f)".

(h) NEW SECTION 30.—Paragraph (5) of new section 30(b) (relating to credit for producing fuel from a nonconventional source) is amended to read as follows:

"(5) APPLICATION WITH OTHER CREDITS.—The credit allowed by subsection (a) for a taxable year shall not exceed the taxpayer's tax liability for the taxable year (as defined in section 25(b)), reduced by the sum of the credits allowable under subpart A and sections 28 and 29."

(i) New Section 33.—New section 33 (relating to tax withheld at source on nonresident aliens and foreign corporations and on tax-free covenant bonds) is amended to read as follows:

"SEC. 33. TAX WITHHELD AT SOURCE ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS.

"There shall be allowed as a credit against the tax imposed by this subtitle the amount of tax withheld at source under subchapter A of chapter 3 (relating to withholding of tax on nonresident aliens and on foreign corporations)."

(j) New Section 40.—New section 40 (relating to alcohol used as fuel) is amended—

(1) by amending subsection (a) to read as follows:

"(a) General Rule.—For purposes of section 38, the alcohol fuels credit determined under this section for the taxable year is an amount equal to the sum of—

"(1) the alcohol mixture credit, plus

"(2) the alcohol credit.",

(2) by striking out "the credit allowable under this section" in subsection (c) and inserting in lieu thereof "the credit determined under this section",

(3) by striking out "credit was allowable" each place it appears in paragraph (3) of subsection (d) and inserting in lieu thereof "credit was determined",

(4) by striking out subsection (e) and redesignating subsection (f) as subsection (e), and

(5) by amending paragraph (2) of subsection (e) (as redesignated by paragraph (4)) to read as follows:

"(2) NO CARRYOVERS TO YEARS AFTER 1994.—No amount may be carried under section 39 by reason of this section (treating the amount allowed by reason of this section as the last amount allowed by this subpart) to any taxable year beginning after December 31, 1994."

(k) NEW SECTION 41.—New section 41 (relating to credit for increasing research activities) is amended—

(1) by amending subsection (a) to read as follows:

"(a) GENERAL RULE.—For purposes of section 38, the research credit determined under this section for the taxable year is an amount equal to 25 percent of the excess (if any) of—

"(1) the qualified research expenses for the taxable year, over

"(2) the base period research expenses.",

(2) by striking out "in computing the credit under section 40 or 44B" in subsection (b)(2)(D)(iii) and in-

serting in lieu thereof "in determining the targeted jobs credit under section 51(a)",

(3) by striking out "the credit (if any) allowable by this section to each" in subparagraphs (A)(ii) and (B)(ii) of subsection (f)(1) and inserting in lieu thereof "the credit (if any) determined under this section for each", and

(4) by amending subsection (g) to read as follows:

"(g) SPECIAL LIMITATION IN THE CASE OF INDIVIDUALS.—

"(1) IN GENERAL.—In the case of an individual who—

"(A) owns an interest in an unincorporated trade or business,

"(B) is a partner in a partnership,

"(C) is a beneficiary of an estate or trust, or

"(D) is a shareholder in an S corporation,

the amount of the credit determined under subsection (a) for any taxable year shall not exceed an amount (separately computed with respect to such person's interest in such trade or business or entity) equal to the amount of tax attributable to that portion of the individual's taxable income which is allocable or apportionable to the individual's interest in such trade or business or entity.

"(2) CARRYOVER.—Any amount by which the credit determined under subsection (a) for any taxable year is reduced under paragraph (1) shall be added to the credit determined under subsection (a) for the succeeding taxable year."

(l) NEW SECTION 42.—New section 42 (relating to employee stock ownership plan) is amended—

(1) by amending paragraph (1) of subsection (a) to read as follows:

"(1) AMOUNT OF CREDIT.—In the case of a corporation which elects to have this section apply for the taxable year and which meets the requirements of subsection (c)(1), for purposes of section 38, the amount of the employee stock ownership credit determined under this section for the taxable year is an amount equal to the amount of the credit determined under paragraph (2) for such taxable year.",

(2) by amending subsection (b) to read as follows:

"(b) CERTAIN REGULATED COMPANIES.—Compensation taken into account for the ratemaking purposes involved shall not be taken into account for purposes of determining the amount of the credit under this section if—

"(1) the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by reason of any portion of such credit which results from the transfer of employer securities or cash to a tax credit employee stock ownership plan which meets the requirements of section 409;

"(2) the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of such credit which results from a transfer described in paragraph (1) to such employee stock ownership plan; or

"(3) any portion of the amount of such credit which results from a transfer described in paragraph (1) to such employee stock ownership plan is treated for ratemaking purposes in any way other than as though it had been contributed by the taxpayer's common shareholders.

Under regulations prescribed by the Secretary, rules similar to the rules of paragraphs (4) and (7) of section 46(f) shall apply for purposes of the preceding sentence.", and

(3) by striking out "the credit allowed under this section" in subsection (c)(3) and inserting in lieu thereof "the credit determined under this section".

(m) REPEAL OF CERTAIN OLD PROVISIONS.—

(1) Old sections 38, 40, 44, and 44B are hereby repealed.

(2) Old subpart C of part IV of subchapter A of chapter 1 is hereby repealed.

(n) REDESIGNATION OF OLD SUBPARTS.—

(1) Old subparts B and D of part IV of subchapter A of chapter 1 are redesignated as subparts E and F, respectively.

(2) The table of subparts for such part IV (as amended by subsection (a) of section 802) is amended by adding at the end thereof the following:

"Subpart E. Rules for computing credit for investment in certain depreciable property.
"Subpart F. Rules for computing targeted jobs credit."

(o) INVESTMENT TAX CREDIT.—

(1) Section 46 (relating to amount of investment tax credit) is amended by striking out subsections (a) and (b) and inserting in lieu thereof the following:

"(a) AMOUNT OF INVESTMENT CREDIT.—For purposes of section 38, the amount of the investment credit determined under this section for any taxable year shall be an amount equal to the sum of the following percentages of the qualified investment (as determined under subsections (c) and (d)):

"(1) the regular percentage,

"(2) in the case of energy property, the energy percentage, and

"(3) in the case of that portion of the basis of any property which is attributable to qualified rehabilitation expenditures, the rehabilitation percentage.

"(b) DETERMINATION OF PERCENTAGES.—For purposes of subsection (a)—

“(1) REGULAR PERCENTAGE.—The regular percentage is 10 percent.

“(2) ENERGY PERCENTAGE.—

“(A) IN GENERAL.—The energy percentage shall be determined in accordance with the following table:

Column A—Description	Column B—Percentage	Column C—Period	
In the case of:	The energy percentage is:	For the period:	
		Beginning on:	And ending on:
(i) GENERAL RULE.—Property not described in any of the following provisions of this column.	10 percent	Oct. 1, 1978	Dec. 31, 1982.
(ii) SOLAR WIND, OR GEOTHERMAL PROPERTY.—Property described in section 48(l)(2)(A)(ii) or 48(l)(3)(A)(vii).	A. 10 percent B. 15 percent	Oct. 1, 1978 Jan. 1, 1980	Dec. 31, 1979. Dec. 31, 1985.
(iii) OCEAN THERMAL PROPERTY.—Property described in section 48(l)(3)(A)(ix).	15 percent	Jan. 1, 1980	Dec. 31, 1985.
(iv) QUALIFIED HYDROELECTRIC GENERATING PROPERTY.—Property described in section 48(l)(2)(A)(vii).	11 percent	Jan. 1, 1980	Dec. 31, 1985.
(v) QUALIFIED INTERCITY BUSES.—Property described in section 48(l)(2)(A)(ix).	10 percent	Jan. 1, 1980	Dec. 31, 1985.
(vi) BIOMASS PROPERTY.—Property described in section 48(l)(15).	10 percent	Oct. 1, 1978	Dec. 31, 1985.

Column A—Description	Column B—Percentage	Column C—Period	
		For the period:	
In the case of:	The energy percentage is:	Beginning on:	And ending on:
(vii) CHLOR-ALKALI ELECTROLYTIC CELLS.—Property described in section 48(l)(5)(M).	10 percent	Jan. 1, 1980	Dec. 31, 1982.

"(B) PERIODS FOR WHICH PERCENTAGE NOT SPECIFIED.—In the case of any energy property, the energy percentage shall be zero for any period for which an energy percentage is not specified for such property under subparagraph (A) (as modified by subparagraphs (C) and (D)).

"(C) LONGER PERIOD FOR CERTAIN LONG-TERM PROJECTS.—For the purpose of applying the energy percentage contained in clause (i) of subparagraph (A) with respect to property which is part of a project with a normal construction period of 2 years or more (within the meaning of section 46(d)(2)(A)(i)), 'December 31, 1990' shall be substituted for 'December 31, 1982' if—

"(i) before January 1, 1983, all engineering studies in connection with the commencement of the construction of the project have been completed and all environmental and construction permits required under Federal, State, or local law in connection with the commencement of the construction of the project have been applied for, and

"(ii) before January 1, 1986, the taxpayer has entered into binding contracts for the acquisition, construction, reconstruction, or erection of equipment specially designed for the project and the aggregate cost to the taxpayer of that equipment is at least 50 percent of the reasonably estimated cost for all such equipment which is to be placed in service as part of the project upon its completion.

"(D) LONGER PERIOD FOR CERTAIN HYDROELECTRIC GENERATING PROPERTY.—If an application has been docketed by the Federal Energy Regulatory Commission before January 1, 1986, with respect to the installation of any qualified hydroelectric generating property, for purposes of applying the energy percentage contained in clause (iv) of subparagraph (A) with respect to such property, 'December 31, 1988' shall be substituted for 'December 31, 1985'.

"(3) SPECIAL RULE FOR CERTAIN ENERGY PROPERTY.—The regular percentage shall not apply to any energy property which, but for section 48(l)(1), would not be section 38 property. In the case of any qualified hydroelectric generating property which is a fish passageway, the preceding sentence shall not apply to any period after 1979 for which the energy percentage for such property is greater than zero.

"(4) Rehabilitation percentage.—

"(A) In general.—

"In the case of qualified rehabilitation expenditures with respect to a:	The rehabilitation percentage is:
30-year building	15
40-year building	20
Certified historic structure	25.

"(B) REGULAR AND ENERGY PERCENTAGES NOT TO APPLY.—The regular percentages and the energy percentages shall not apply to that portion of the basis of any property which is attributable to qualified rehabilitation expenditures.

"(C) DEFINITIONS.—For purpose of this paragraph—

"(i) 30-YEAR BUILDING.—The term '30-year building' means a qualified rehabilitated building other than a 40-year building and other than a certified historic structure.

"(ii) 40-YEAR BUILDING.—The term '40-year building' means a qualified rehabilitated building (other than a certified historic structure) which would meet the requirements of section 48(g)(B) if '40' were substituted for '30' each place it appears in subparagraph (B) thereof.

"(iii) CERTIFIED HISTORIC STRUCTURE.—The term 'certified historic structure' means a qualified rehabilitated building which meets the requirements of section 48(g)(3)."

(2) Subclause (II) of section 46(c)(8)(F)(ii) is amended by striking out "section 46(a)(2)(C)" and inserting in lieu thereof "subsection (b)(2)".

(3)(A) Paragraph (1) of section 46(e) is amended—

(i) by striking out "and the $25,000 amount specified under subparagraphs (A) and (B) of subsection (a)(3)", and

(ii) by striking out "such items" and inserting in lieu thereof "such qualified investment".

(B) Paragraph (2) of section 46(e) is amended by striking out "the items described therein" and inserting in lieu thereof "qualified investment".

(4) Paragraph (8) of section 46(f) is amended by striking out "(within the meaning of subsection (a)(7)(C))" and inserting in lieu thereof "(within the meaning of the first sentence of subsection (c)(3)(B))".

(5) Subsection (f) of section 46 is amended by striking out paragraph (9) and by redesignating paragraph (10) as paragraph (9).

(6) Paragraph (2) of section 46(g) is amended by striking out "the limitation of subsection (a)(3)" and inserting in lieu thereof "the limitation of section 38(c)".

(7) Paragraph (1) of section 46(h) is amended by striking out "the limitation contained in subsection (a)(3)" and inserting in lieu thereof "the limitation contained in section 38(c)".

(8) Paragraphs (5) and (6) of section 47(a) are each amended by striking out "under section 46(b)" and inserting in lieu thereof "under section 39".

(9) Subsection (c) of section 47 is amended by striking out "subpart A" and inserting in lieu thereof "subpart A, B, or D".

(10) Subparagraph (B) of section 48(c)(3) is amended by striking out "section 46(b)" and inserting in lieu thereof "section 39".

(11) Subparagraph (B) of section 48(d)(1) is amended by striking out "section 46(a)(6)" and inserting in lieu thereof "section 38(c)(3)(B)".

(12) Subsection (f) of section 48 is amended—

(A) by adding "and" at the end of paragraph (1),

(B) striking out ", and" at the end of paragraph (2) and inserting in lieu thereof a period, and

(C) by striking out paragraph (3).

(13) Paragraph (1) of section 48(l) is amended by striking out "section 46(a)(2)(C)" and inserting in lieu thereof "section 46(b)(2)".

(14) Subsection (m) of section 48 is amended by striking out "subsection (a)(2)" and inserting in lieu thereof "subsection (b)".

(15) Subsection (n) of section 48 (relating to requirements for allowance of employee plan percentage) is hereby repealed.

(16) Subsection (o) of section 48 (defining certain credits) is amended by striking out paragraphs (3), (4), (5), (6), and (7) and by redesignating paragraph (8) as paragraph (3).

(17) Subsection (q) of section 48 is amended—

(A) by striking out "section 46(a)(2)" each place it appears and inserting in lieu thereof "section 46(a)", and

(B) by striking out "section 46(a)(2)(B)" each place it appears and inserting in lieu therof "section 46(b)(1)".

(18) Subsection (r) of section 48 is amended by striking out "section 381(c)(23)" and inserting in lieu thereof "section 381(c)(25)".

(p) TARGETED JOBS CREDIT.—

(1) Subsection (a) of section 51 (relating to amount of targeted jobs credit) is amended to read as follows:

"(a) DETERMINATION OF AMOUNT.—For purposes of section 38, the amount of the targeted jobs credit determined under this section for the taxable year shall be the sum of—

"(1) 50 percent of the qualified first-year wages for such year, and

"(2) 25 percent of the qualified second-year wages for such year."

(2) Subsection (g) of section 51 is amended by striking out "the credit provided by section 44B" and inserting in lieu thereof "the targeted jobs credit determined under this subpart".

(3) Subsection (a) of section 52 is amended by striking out "the credit (if any) allowable by section 44B to each such member" and inserting in lieu thereof "the credit (if any) determined under section 51(a) with respect to each such member".

(4) Subsection (b) of section 52 is amended by striking out "the credit (if any) allowable by section

44B" and inserting in lieu thereof "the credit (if any) determined under section 51(a)".

(5) Subsection (c) of section 52 is amended by striking out "credit shall be allowed under section 44B" and inserting in lieu thereof "credit shall be allowed under section 38 for any targeted jobs credit determined under this subpart".

(6) Paragraph (2) of section 52(d) is amended by striking out ", subject to section 53, a credit under section 44B" and inserting in lieu thereof ", subject to section 38(c), a credit under section 38(a)".

(7) Section 53 (relating to limitation based on amount of tax) is hereby repealed.

(8) The table of sections for old subpart D of part IV of subchapter A of chapter 1 is amended by striking out the item relating to section 53.

(q) SECTION 55.—

(1) Paragraph (1) of section 55(c) (relating to credits) is amended—

(A) by striking out "subpart A of part IV" and inserting in lieu thereof "subpart A, B, or D of part IV", and

(B) by striking out "section 33(a)" each place it appears and inserting in lieu thereof "section 28(a)".

(2) Clause (i) of section 55(c)(2)(B) is amended by striking out "section 33(a)" and inserting in lieu thereof "section 28(a)".

(3) Paragraph (3) of section 55(c) is amended to read as follows:

"(3) CARRYOVER AND CARRYBACK OF CERTAIN CREDITS.—In the case of any taxable year for which a tax is imposed by this section, for purposes of determining the amount of any carryover or carryback to any other taxable year of any credit allowable under section 23 or 38, the amount of the limitation under section 25 or 38(c) (as the case may be) shall be deemed to be—

"(A) the amount of such limitation for such taxable year (determined without regard to this paragraph), reduced (but not below zero) by

"(B) the amount of the tax imposed by this section for the taxable year, reduced by—

"(i) the amount of the credit allowable under section 28(a), and

"(ii) in the case of the limitation under section 38(c), the amount of such tax taken into account under this clause with respect to the limitation under section 25."

(4) Paragraph (2) of section 55(f) is amended by striking out "allowable under subpart A of part IV of this subchapter (other than under sections 31, 39, and 43)" and inserting in lieu thereof "allowable under subparts A, B, and D of part IV of this subchapter".

(r) TECHNICAL AND CONFORMING AMENDMENTS TO OTHER PROVISIONS.—

(1) SECTION 56.—

(A) Subsection (c) of section 56 (defining regular tax deduction) is amended—

(i) by striking out "subpart A of part IV other than sections 39 and 44G" and inserting in lieu thereof "subparts A, B, and D of part IV", and

(ii) by amending the last sentence to read as follows: "For purposes of the preceding sentence, the amount of the credit determined under section 38 for any taxable year shall be determined without regard to the employee stock ownership credit determined under section 42."

(B) Subparagraph (A) of section 56(e)(1) is amended by striking out clauses (i), (ii), (iii), and (iv) and inserting in lieu thereof the following:

"(i) section 28 (relating to foreign tax credit), and

"(ii) section 38 (relating to general business credit), exceed".

(2) SECTION 86.—Paragraph (1) of section 86(f) (relating to treatment as pension or annuity for certain purposes) is amended by striking out "section 43(c)(2)" and inserting in lieu thereof "section 32(c)(2)".

(3) SECTION 87.—Section 87 (relating to alcohol fuel credit included in income) is amended to read as follows:

"SEC. 87. ALCOHOL FUEL CREDIT.

"Gross income includes the amount of the alcohol fuel credit determined with respect to the taxpayer for the taxable year under section 40(a)."

(4) SECTION 103.—Clause (iv) of section 103(b)(6)(F) (relating to certain capital expenditures not taken into account) is amended by striking out "section 44F(b)(2)(A)" and inserting in lieu thereof "section 41(b)(2)(A)".

(5) SECTION 108.—Subparagraph (B) of section 108(b)(2) (relating to reduction of tax attributes in title 11 case or insolvency) is amended to read as follows:

"(B) GENERAL BUSINESS CREDIT.—Any carryover to or from the taxable year of the discharge of an amount for purposes of determining the amount of the credit allowable under section 38 (relating to general business credit). For purposes of this subparagraph, there shall not be taken into account any portion of a carryover which is attributable to the employee stock ownership credit determined under section 42."

(6) SECTION 129.—

(A) Paragraph (2) of section 129(b) (relating to earned income limitation) is amended by striking out "section 44A(e)(2)" and inserting in lieu thereof "section 21(d)(2)".

(B) Paragraph (1) of section 129(e) (defining dependent care assistance) is amended by striking out "section 44A(c)(2)" and inserting in lieu thereof "section 21(b)(2)".

(C) Paragraph (2) of section 129(e) (defining earned income) is amended by striking out "section 43(c)(2)" and inserting in lieu thereof "section 32(c)(2)".

(7) SECTION 168.—

(A) Clause (i) of section 168(i)(1)(D), as added by section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "subpart A of part IV" and inserting in lieu thereof "subparts A, B, and D of part IV".

(B) Clause (iii) of section 168(i)(1)(D), as added by section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "under the last sentence of section 53(a)" and inserting in lieu thereof "under section 25(b)(2)".

(C) Subparagraph (A) of section 168(i)(4), as added section 208(a) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "subpart A of part IV of subchapter A of this chapter" and inserting in lieu thereof "section 38".

(D) Clause (i) of section 168(i)(1)(D), as added by section 209(b) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "subpart A of part IV" and inserting in lieu thereof "subparts A, B, and D of part IV".

(E) Clause (iii) of section 168(i)(1)(D), as added by section 209(b) of the Tax Equity and Fiscal Responsibility Act of 1982, is amended by striking out "under the last sentence of section

53(a)" and inserting in lieu thereof "under section 25(b)(2)".

(8) SECTION 196.—

(A) Subsection (a) of section 196 (relating to deduction for certain unused investment credits) is amended to read as follows:

"(a) ALLOWANCE OF DEDUCTION.—If any portion of the investment credit determined under section 46(a) for any taxable year has not, after the application of section 38(c), been allowed to the taxpayer as a credit under section 38 for any taxable year, an amount equal to 50 percent of such credit not so allowed (to the extent attributable to property the basis of which is reduced under section 48(q)) shall be allowed to the taxpayer as a deduction for the first taxable year following the last taxable year in which such credit could under section 39 have been allowed as a credit."

(B) Subsection (b) of section 196 is amended by striking out "the excess described in subsection (a) could under section 46(b)" and inserting in lieu thereof "the credit described in subsection (a) could under section 39".

(9) SECTION 213.—Subsection (e) of section 213 (relating to exclusion of amounts allowed for care of certain dependents) is amended by striking out "section 44A" and inserting in lieu thereof "section 21".

(10) SECTION 280C.—

(A) Section 280C (relating to certain expenses for which credits are allowable) is amended by striking out subsection (a) and by redesignating subsections (b) and (c) as subsections (a) and (b), respectively.

(B) Subsection (a) of section 280C (as so redesignated) is amended—

(i) by striking out the first sentence and inserting in lieu thereof the following: "No deduction shall be allowed for that portion of the wages or salaries paid or incurred for the taxable year which is equal to the amount of the credit determined for the taxable year under section 51(a).", and

(ii) by striking out "SECTION 44B CREDIT" in the subsection heading and inserting in lieu thereof "TARGETED JOBS CREDIT".

(C) Subsection (b) of section 280C (as so redesignated) is amended by striking out "44H" each place it appears and inserting in lieu thereof "30".

(D) Paragraph (3) of section 280C(b) (as so redesignated) is amended—

(i) by striking out "section 44F(f)(5)" and inserting in lieu thereof "section 41(f)(5)",

(ii) by striking out "section 44F(f)(1)(B)" and inserting in lieu thereof "section 41(f)(1)(B)",

(iii) by striking out "section 44F(f)(1)" and inserting in lieu thereof "section 41(f)(1)".

(11) SECTION 381.—Subsection (c) of section 381 is amended—

(A) by striking out paragraphs (23), (24), (26), (27), (29), and (30),

(B) by redesignating paragraphs (25) and (28) as paragraphs (23) and (24), respectively, and

(C) by adding at the end thereof the following new paragraph:

"(25) CREDIT UNDER SECTION 38.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 38, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 38 in respect of the distributor or transferor corporation."

(12) SECTION 383.—

(A) Section 383 (as in effect on the day before the date of the enactment of the Tax Reform Act of 1976) is amended—

(i) by striking out "with respect to any unused investment credit" and all that follows and inserting in lieu thereof the following: "with respect to any unused business credit of the corporation which can otherwise be carried forward under section 39, to any excess foreign taxes of the corporation which could otherwise be carried forward under section 904(d), and to any net capital loss of the corporation which can otherwise be carried forward under section 1212.", and

(ii) by striking out the section heading and inserting in lieu thereof the following:

"SEC. 383. SPECIAL LIMITATIONS ON UNUSED BUSINESS CREDITS, FOREIGN TAXES, AND CAPITAL LOSSES."

(B) Section 383 (as amended by the Tax Reform Act of 1976) is amended—

(i) by striking out "with respect to any unused investment credit" and all that follows and inserting in lieu thereof the following: "with respect to any unused business credit of the corporation under section 39, to any excess foreign taxes of the corporation under section 904(c), and to any net capital loss of the corporation under section 1212.", and

(ii) by striking out the section heading and inserting in lieu thereof the following:

"SEC. 383. SPECIAL LIMITATIONS ON UNUSED BUSINESS CREDITS, FOREIGN TAXES, AND CAPITAL LOSSES."

(C) The table of sections for part V of subchapter C of chapter 1 is amended by striking out the item relating to section 383 and inserting in lieu thereof the following:

"Sec. 383. Special limitations on unused business credits, foreign taxes, and capital losses."

(13) Paragraph (21) of section 401(a) is amended by striking out "allowable—" and all that follows and inserting in lieu thereof "allowable under section 41 if the employer made the transfer described in section 41(c)(1)(B)."

(14) SECTION 404.—Subsection (i) of section 404 (relating to deductibility of unused portions of employee stock ownership credit) is amended to read as follows:

"(i) DEDUCTIBILITY OF UNUSED PORTIONS OF EMPLOYEE STOCK OWNERSHIP CREDIT.—

"(1) UNUSED CREDIT CARRYOVERS.—If any portion of the employee stock ownership credit determined under section 42 for any taxable year has not, after the application of section 38(c), been allowed under section 38 for any taxable year, such portion shall be allowed as a deduction (without regard to any limitations provided under this section) for the last taxable year to which such portion could have been allowed as a credit under section 39.

"(2) REDUCTIONS IN CREDIT.—There shall be allowed as a deduction (subject to the limitations provided under this section) an amount equal to any reduction of the credit allowed under section 42 resulting from a final determination of such credit to the extent such reduction is not taken into account under section 42(c)(3)."

(14) SECTION 409.—

(A) Section 409 (relating to qualifications for tax credit employee stock ownership plans), as redesignated by section 901(d) of this Act, is amended by striking out "44G" each place it appears in subsections (b), (g), (i), (m), and (n) and inserting in lieu thereof "42".

(B) Paragraph (1) of section 409(b), as so redesignated, is amended by striking out "48(n)(1)(A) or".

(C) Subsection (g) of section 409, as so redesignated, is amended by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, the references to section 48(n)(1) and the employee plan credit shall refer to such section and credit as in effect before the enactment of the Tax Law Simplification and Improvement Act of 1983."

(D) Subparagraph (A) of section 409(i)(1), as so redesignated, is amended by striking out "48(n)(1) or".

(E) Subsection (k) of section 409, as so redesignated, is amended by adding at the end thereof the following new sentence: "For purposes of this subsection, the reference to the matching employee plan credit shall refer to such credit as in effect before the enactment of the Tax Law Simplification and Improvement Act of 1983."

(16) SECTION 527(g)(1).—Paragraph (1) of section 527(g) (relating to treatment of newsletter funds) is amended by striking out "section 41(c)(2)" and inserting in lieu thereof "section 24(c)(2)".

(17) SECTION 642(a)(2).—Paragraph (2) of section 642(a) (relating to credit for political contributions) is amended by striking out "section 41" and inserting in lieu thereof "section 24".

(18) SECTION 691(b).—Subsection (b) of section 691 (relating to allowance of deductions and credit) is amended by striking out "section 33" each place it appears and inserting in lieu thereof "section 28".

(19) SECTIONS 874(a) AND 882(c)(2).—Sections 874(a) and 882(c)(2) are each amended—

(A) by striking out "32" and inserting in lieu thereof "33", and

(B) by striking out "section 39" and inserting in lieu thereof "section 34".

(20) SECTION 901(a).—Subsection (a) of section 901 (relating to allowance of foreign tax credit) is amended by striking out the last sentence and inserting in lieu thereof the following: "The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 25(b)."

(21) SECTION 904(g).—Subsection (g) of section 904 (relating to limitation on foreign tax credit) is amended to read as follows:

"(g) COORDINATION WITH NONREFUNDABLE PERSONAL CREDITS.—In the case of an individual, for purposes of subsection (a), the tax against which the credit is taken is such tax reduced by the sum of the credits allowable under subpart A of part IV of subchapter A of this chapter."

(22) SECTION 936.—

(A) Clause (i)(I)(a) of section 936(h)(5)(C) is amended by striking out "section 44F(b)" and inserting in lieu thereof "section 41(b)".

(B) Clause (i)(IV)(c) of section 936(h)(5)(C) is amended—

(i) by striking out "section 44F" and inserting in lieu thereof "section 41", and

(ii) by striking out "section 44F(f)" and inserting in lieu thereof "section 41(f)".

(23) SECTION 1016(a)(21).—Paragraph (21) of section 1016(a) (relating to adjustments to basis) is amended—

(A) by striking out "section 44C(e)" and inserting in lieu thereof "section 23(e)", and

(B) by striking out "section 44C" and inserting in lieu thereof "section 23".

(24) SECTION 1033(g)(3)(A).—Subparagraph (A) of section 1033(g)(3) (relating to election to treat outdoor advertising displays as real property) is amended by striking out "the credit allowed by section 38 (relating to investment in certain depreciable property)" and in-

serting in lieu thereof "the investment credit determined under section 46(a)".

(25) SECTION 1351(i).—Subsection (i) of section 1351 (relating to adjustments for succeeding years) is amended—

(A) by striking out "section 33" and inserting in lieu thereof "section 28", and

(B) by striking out "section 38 (relating to investment credit)" and inserting in lieu thereof "section 38 (relating to general business credit)".

(26) SECTION 1366(f).—Paragraph (1) of section 1366(f) (relating to special rules) is amended by striking out "section 39" each place it appears and inserting in lieu thereof "section 34".

(27) SECTION 1374(b).—Subsection (b) of section 1374 (relating to amount of tax imposed on certain capital gains) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

(28) SECTION 1375(c).—Paragraph (1) of section 1375(c) (relating to disallowance of credit) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

(29) SECTION 1451.—

(A) Chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations and tax-free covenant bonds) is amended by striking out subchapter B and by redesignating subchapter C as subchapter B.

(B) The table of subchapters for chapter 3 is amended by striking out the items relating to subchapters B and C and inserting in lieu thereof the following:

"SUBCHAPTER B. Application of withholding provisions."

(C) The heading of chapter 3 is amended by striking out "**AND TAX-FREE COVENANT BONDS**".

(D) The table of chapters for subtitle A is amended by striking out "and tax-free covenant bonds" in the item relating to chapter 3.

(E) Section 12 is amended by striking out paragraph (6) and by redesignating paragraphs (7) and (8) as paragraphs (6) and (7), respectively.

(F) Subsection (f) of section 164 is amended by striking out paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively.

(G) Subsection (a) of section 1441 is amended by striking out "except in the cases provided for in section 1451 and".

(H) Paragraph (3) of section 1441(c) is amended by striking out "section 1451" and inserting in lieu thereof "section 1451 (as in effect before its repeal by the Tax Credit Simplification Act of 1983)".

(I) 'Subsection (a) of section 1442 is amended—

(i) by striking out "or section 1451", and

(ii) by striking out "; except that, in the case of interest described in section 1451 (relating to tax-free covenant bonds), the deduction and withholding shall be at the rate specified therein".

(J) Paragraph (2) of section 3454(a) (relating to amounts not treated as interest) is amended—

(i) by adding "and" at the end of clause (v) of subparagraph (G),

(ii) by striking out subparagraph (H), and

(iii) by redesignating subparagraph (I) as subparagraph (H).

(K) Paragraph (2) of section 6049(b) (relating to amounts not treated as interest) is amended—

(i) by adding "and" at the end of subparagraph (C),

(ii) by striking out ", and" at the end of subparagraph (D) and inserting in lieu thereof a period, and

(iii) by striking out subparagraph (E).

(L) Paragraph (16) of section 7701(a) is amended by striking out "1451,".

(30) SECTION 3452(b).—Paragraph (5) of section 3452(b) (defining income tax liability) is amended by striking out "(other than credits allowable by sections 31, 39, and 43)" and inserting in lieu thereof "other than credits allowable under subpart C of part IV of subchapter A of chapter 1)".

(31) SECTION 4094.—Section 4094 (relating to cross reference) is amended by striking out "sections 39" and inserting in lieu thereof "sections 34".

(32) SECTION 6096(b).—Subsection (b) of section 6096 (defining income tax liability) is amended by striking out "allowable under sections 33, 37, 38, 40, 41, 42, 44, 44A, 44B, 44C, 44D, 44E, 44F, 44G, amd 44H" and inserting in lieu thereof "allowable under part IV of subchapter A of chapter 1 (other than subpart C thereof)".

(33) SECTION 6201(a)(4).—Paragraph (4) of section 6201(a) (relating to erroneous credit under section 39 or 43) is amended—

(A) by striking out "section 39" and inserting in lieu thereof "section 34",

(B) by striking out "section 43" and inserting in lieu thereof "section 32", and

(C) by striking out "SECTION 39 OR 43" in the paragraph heading and inserting in lieu thereof "SECTION 32 OR 34".

(34) SECTION 6211(b).—

(A) Paragraph (1) of section 6211(b) is amended by striking out "without regard to so much of the credit under section 32 as exceeds 2 percent of the interest on obligations described in section 1451" and inserting in lieu thereof "without regard to the credit under section 33".

(B) Paragraph (4) of section 6211(b) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

(35) SECTION 6213(h)(3).—Paragraph (3) of section 6213(h) is amended by striking out "section 39" and inserting in lieu thereof "section 32 or 34".

(36) SECTION 6362(c)(1).—Paragraph (1) of section 6362(c) (relating to qualified resident tax which is a percentage of the Federal tax) is amended by striking out "sections 31 and 39" and inserting in lieu thereof "sections 31 and 34".

(37) SECTION 6401(b).—

(A) The first sentence of section 6401(b) (relating to excessive credits treated as overpayments) is amended to read as follows: "If the amount allowable as credits under subpart C of part IV of subchapter A of chapter 1 (relating to refundable credits) exceeds the tax imposed by subtitle A (reduced by the credits allowable under subparts A, B, and D of such part IV), the amount of such excess shall be considered an overpayment."

(B) The second sentence of section 6401(b) is amended by striking out "paragraph (1) of section 32" and inserting in lieu thereof "section 33".

(38) SECTION 6411.—

(A) So much of subsection (a) of section 6411 as precedes paragraph (2) thereof (relating to tentative carryback and refund adjustments) is amended to read as follows:

"(a) APPLICATION FOR ADJUSTMENT.—A taxpayer may file an application for a tentative carryback adjustment of the tax for the prior taxable year affected by a net operating loss carryback provided in section 172(b), by a business credit carryback provided in section 39, or by a capital loss carryback provided in section 1212(a)(1), from any taxable year. The application shall be verified in the manner prescribed by section 6065 in the case of a return of such taxpayer and shall be filed, on or after the date of filing for the return for the taxable year of the net operating loss, net capital loss, or unused business credit from which the carryback results and within a period of 12 months after such taxable year (or, with respect to any portion of a business credit carryback attributable to a net operating loss carryback or a net capital loss carryback) from a subsequent taxable year within a period of 12 months from the end of such subsequent taxable year, in the manner and form required by regulations prescribed by the Secretary. The applications shall set forth in such detail and with such supporting data and explanation as such regulations shall require—

"(1) The amount of the net operating loss, net capital loss, or unused business credit;".

(B) Subsections (b) and (c) of section 6411 are each amended by striking out "unused investment credit, unused work incentive program credit, unused new employee credit, unused research credit, or unused employee stock ownership credit" each place it appears and inserting in lieu thereof "or unused business credit".

(39) SECTIONS 6420(g)(2), ETC.—Sections 6420(g)(2), 6421(i)(3), and 6427(i)(3) are each amended

by striking out "section 39" and inserting in lieu thereof "section 34".

(40) SECTION 6501(p).—Section 6501 is amended by striking out subsection (p) and by redesignating subsection (q) as subsection (p).

(41) SECTION 6511(d)(4)(C).—Subparagraph (C) of section 6511(d)(4) (defining credit carryback) is amended to read as follows:

"(C) CREDIT CARRYBACK DEFINED.—For purposes of this paragraph, the term 'credit carryback' means any business carryback under section 39."

(42) SECTION 7871.—Subparagraph (A) of section 7871(a)(6) is amended by striking out "section 41(c)(4)" and inserting in lieu thereof "section 24(c)(4)".

(43) SECTION 9502(d).—Paragraph (3) of section 9502(d) (relating to transfers from the Airport and Airway Trust Fund on account of certain section 39 credits) is amended—

(A) by striking out "section 39" and inserting in lieu thereof "section 34", and

(B) by striking out "SECTION 39 CREDITS" in the heading and inserting in lieu thereof "SECTION 34 CREDITS".

(44) Section 9503(c).—Clause (ii) of section 9503(c)(2)(A) (relating to transfers from the Highway Trust Fund for certain repayments and credits) is amended by striking out "section 39" and inserting in lieu thereof "section 34".

SEC. 806. EFFECTIVE DATES.

(a) General Rule.—The amendments made by this title shall apply to taxable years beginning after December 31, 1983, and to carrybacks from such years.

(b) Tax-Free Covenant Bonds.—The amendments made by subsections (i) and (r)(29) of section 805 shall not apply with respect to obligations issued before January 1, 1984.

TITLE IX—REPEAL OF CERTAIN OBSOLETE PROVISIONS

SEC. 901. TERMINATION OF RULES RELATING TO QUALIFIED BOND PURCHASE PLANS AND RETIREMENT BONDS WITH RESPECT TO BONDS ISSUED AFTER DECEMBER 31, 1983.

(a) Qualified Bond Purchase Plans.—Section 405 (relating to qualified bond purchase plans) is hereby repealed.

(b) Retirement Bonds.—Section 409 (relating to retirement bonds) is hereby repealed.

(c) Technical and Conforming Amendments.—

(1) Paragraph (2) of section 55(f) (defining regular tax) is amended by striking "409(c),".

(2) Paragraph (7) of section 62 (defining adjusted gross income) is amended—

(A) by striking out "the deductions allowed by section 404 and section 405(c)" and inserting in lieu thereof "the deduction allowed by section 404", and

(B) by striking out "ANNUITY, AND BOND PURCHASE" in the heading and inserting in lieu thereof "AND ANNUITY".

(3) Subparagraph (B) of section 72(m)(9) is amended by striking out "or 405(a)".

(4) Paragraph (1) of section 72(o) is amended by striking out "402, 403, and 405" and inserting in lieu thereof "402 and 403".

(5) Paragraph (4) of section 72(o) is amended by striking out "408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(6) Subparagraph (D) of section 172(d)(4) is amended by striking out "or section 405(c)".

(7) Paragraph (2) of section 219(d) is amended by striking out "405(d)(3), 408(d)(3), or 409(b)(3)(C)" and inserting in lieu thereof "or 408(d)(3)".

(8) Paragraph (1) of section 219(e) is amended by striking out the last sentence.

(9) Paragraph (3) of section 219(e) is amended by striking out subparagraph (C), by adding "and" at the end of subparagraph (B) and by redesignating subparagraph (D) as subparagraph (C).

(10) Clause (iv) of section 402(a)(5)(D) is amended by striking out subclause (III) and by redesignating subclauses (IV) and (V) as subclauses (III) and (IV), respectively.

(11) Clause (i) of section 402(a)(5)(E) is amended by striking out ", (II), or (III)" and inserting in lieu thereof "or (II)".

(12) Clause (ii) of section 402(a)(5)(E) is amended by striking out "(IV) or (V)" and inserting in lieu thereof "(III) or (IV)".

(13) The last sentence of section 403(b)(1) is amended by striking out "or 409(b)(3)(C)".

(14) Subsection (a) of section 406 is amended by striking out ", an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a)" and inserting in lieu thereof "or an annuity plan described in section 403(a)".

(15) Paragraph (3) of section 406(a) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(16) Subsection (d) of section 406 is amended—

(A) by striking out "sections 404 and 405(c)" and inserting in lieu thereof "section 404",

(B) by striking out "annuity, or bond purchase" and inserting in lieu thereof "or annuity", and

(C) by striking out "(or section 405(c))" in paragraph (2) thereof.

(17) Paragraph (1) of section 407(a) is amended by striking out ", an annuity plan described in section 403(a), or a bond purchase plan described in section 405(a)" and inserting in lieu thereof "or an annuity plan described in section 403(a)".

(18) Subparagraph (B) of section 407(a)(1) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(19) Subsection (d) of section 407 is amended—

(A) by striking out "sections 404 and 405(c)" and inserting in lieu thereof "section 404",

(B) by striking out "annuity, or bond purchase" and inserting in lieu thereof "or annuity", and

(C) by striking out "(or section 405(c))" in paragraph (2) thereof.

(20) Paragraph (1) of section 408(a) is amended by striking out "403(b)(8), 405(d)(3), or 409(b)(3)(C)" and inserting in lieu thereof "or 403(b)(8)".

(21) Clause (i) of section 408(d)(3)(A) is amended by striking out "or retirement bond".

(22) Subparagraph (B) of section 408(d)(3) is amended by striking out ", individual retirement annuity, or a retirement bond" and inserting in lieu thereof "or an individual retirement annuity".

(23) Clause (ii) of section 408(d)(3)(C) (relating to partial rollovers) is redesignated as subparagraph (D) and is amended by striking out "bond,".

(24) Paragraph (6) of section 408(d) is amended—

(A) by striking out ", individual retirement annuity, or retirement bond" and inserting in lieu thereof "or an individual retirement annuity", and

(B) by striking out ", annuity, or bond" and inserting in lieu thereof "or annuity".

(25) Subparagraph (E) of section 408(k)(3) is amended by striking out ", 403(a), or 405(a)" and inserting in lieu thereof "or 403(a)".

(26) Paragraph (2) of section 412(a) is amended by striking out "or 405(a)".

(27) Subsection (h) of section 414 is amended by striking out "or 405(a)".

(28) Subsection (l) of section 414 is amended by striking out "or 405".

(29) Paragraph (2) of section 415(a) is amended by striking out subparagraph (D), by striking out "or" at the end of subparagraph (C), by adding "or" at the end of subparagraph (B), and by striking out "405(a),".

(30) Subparagraph (A) of section 415(b)(2) is amended by striking out "408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(31) Subparagraph (B) of section 415(b)(2) is amended by striking out "408(d)(3) and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(32) Paragraph (2) of section 415(c) is amended by striking out "405(d)(3), 408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(33) Paragraph (1) of section 415(k) is amended by striking out subparagraphs (C) and (H), by redesignating subparagraphs (D), (E), (F), and (G) as sub-

paragraphs (C), (D), (E), and (F), respectively, by striking out ", or" at the end of subparagraph (F) (as so redesignated) and inserting in lieu thereof a period, and by adding "or" at the end of subparagraph (E) (as so redesignated).

(34) Paragraph (2) of section 457(e) is amended by striking out subparagraph (C) and by redesignating subparagraphs (D) and (E) as subparagraphs (C) and (D), respectively.

(35) Subsection (e) of section 2039 is amended—

(A) by striking out paragraph (3),

(B) by striking out ", or" at the end of paragraph (2) and inserting in lieu thereof a period,

(C) by adding "or" at the end of paragraph (1),

(D) by striking out "405(d)(3), 408(d)(3), or 409(b)(3)(C)" and inserting in lieu thereof "or 408(d)(3)", and

(E) by striking out ", annuity, or bond" each place it appears and inserting in lieu thereof "or annuity".

(36) Paragraph (5) of section 2517(a) is amended by striking out ", an individual retirement annuity described in section 408(b), or a retirement bond described in section 409(a)" and inserting in lieu thereof

"or an individual retirement annuity described in section 408(b)".

(37) Paragraph (5) of section 3121(a) is amended by striking out subparagraph (C) and by redesignating subparagraphs (D) through (G) as subparagraphs (C) through (F), respectively.

(38) Paragraph (5) of section 3306(b) is amended by striking out subparagraph (C) and by redesignating subparagraphs (D) through (G) as subparagraphs (C) through (F), respectively.

(39) Paragraph (12) of section 3401(a) is amended by striking out subparagraph (C) and by redesignating subparagraph (D) as subparagraph (C).

(40) Subsection (e) of section 209 of the Social Security Act is amended by inserting "(as in effect before the enactment of the Tax Law Simplification and Improvement Act of 1983)" after "Internal Revenue Code of 1954" in paragraph (4) thereof.

(41) Subsection (a) of section 4972 is amended by striking out the last sentence and inserting in lieu thereof "This section applies only to plans which include a trust described in section 401(a) or which are described in section 403(a)."

(42) Subsection (a) of section 4973 is amended—

(A) by striking out paragraph (3),

(B) by striking out "or" at the end of paragraph (2),

(C) by adding "or" at the end of paragraph (1),

(D) by striking out ", annuities, or bonds" and inserting in lieu thereof "or annuities", and

(E) by striking out ", annuity, or bond" and inserting in lieu thereof "or annuity".

(43) Subparagraph (A) of section 4973(b)(1) is amended by striking out "408(d)(3), and 409(b)(3)(C)" and inserting in lieu thereof "and 408(d)(3)".

(44) The last sentence of section 4973(b) is amended by striking out ", individual retirement annuity, or bond" and inserting in lieu thereof "or the individual retirement annuity".

(45) Paragraph (1) of section 4973(c) is amended by striking out ", 408(d)(3)(A)(iii), or 409(b)(3)(C)" and inserting in lieu thereof "or 408(d)(3)(A)(iii)".

(46) The last sentence of section 4975(d) is amended by striking out ", individual retirement annuity, or an individual retirement bond (as defined in section 408 or 409)" and inserting in lieu thereof "or an individual retirement annuity (as defined in section 408)".

(47) Paragraph (1) of section 4975(e) is amended—

(A) by striking out "or 405(a)",

(B) by striking out "or a retirement bond described in section 409",

(C) by striking out "annuity, or bond" and inserting in lieu thereof "or annuity", and

(D) by striking out "account, or bond" and inserting in lieu thereof "or account".

(48) Section 6047 is amended by striking out subsection (c) and by redesignating subsections (d), (e), and (f) as subsections (c), (d), and (e), respectively.

(49) Subsection (e) of section 6058 is amended by striking out paragraph (2) and by redesignating paragraphs (3) and (4) as paragraphs (2) and (3), respectively.

(50) Clause (i) of section 6104(a)(1)(B) is amended by striking out ", 403(a),. or 405(a)" and inserting in lieu thereof "or 403(a)".

(51) Subsection (f) of section 6652 is amended by striking out "and bond purchase".

(52) Section 7207 is amended by striking out "or (c)".

(53) Subsection (c) of section 7476 is amended by striking out paragraph (3), by striking out ", or" at the

end of paragraph (2) and inserting in lieu thereof a period, and by adding ", or" at the end of paragraph (1).

(54) Paragraph (37) of section 7701(a) is amended by striking out subparagraph (C), by striking out ", and" at the end of subparagraph (B) and inserting in lieu thereof a period, and by adding "and" at the end of subparagraph (A).

(55) The table of sections of subpart A of part I of subchapter D of chapter 1 is amended by striking out the items relating to sections 405 and 409.

(56) The section heading for section 4973 is amended by striking out "**CERTAIN INDIVIDUAL RETIREMENT ANNUITIES, AND CERTAIN RETIREMENT BONDS**" and inserting in lieu thereof "**AND CERTAIN INDIVIDUAL RETIREMENT ANNUITIES**".

(57) The table of sections for chapter 43 is amended by striking out "certain individual retirement annuities, and certain retirement bonds" in the item relating to section 4973.

(58) The section heading for section 6047 is amended by striking out "**AND BOND PURCHASE**".

(59) The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by strik-

ing out "and bond purchase" in the item relating to section 6047.

(60) The first sentence of section 3107 of title 31, United States Code, is amended by inserting before the period ", as in effect before the enactment of the Tax Law Simplification and Improvement Act of 1983".

(d) SECTION 409A REDESIGNATED AS SECTION 409.—

(1) The section heading for section 409A is amended by striking out "**SEC. 409A.**" and inserting in lieu thereof "**SEC. 409.**".

(2) Subsections (b)(3)(A) and (c)(1)(A)(i) of section 44G are each amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(3) Paragraph (6) of section 44G(c) is amended by striking out "section 409A(l)" and inserting in lieu thereof "section 409(l)".

(4) Paragraph (22) of section 401(a) is amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(5) Paragraph (23) of section 401(a) is amended by striking out "section 409A(h)" each place it appears and inserting in lieu thereof "section 409(h)".

(6) Clause (ii) of section 415(c)(6)(B) is amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(7) The last sentence of section 1504(a) is amended by striking out "for section 409A(l)" and inserting in lieu thereof "of section 409(l)".

(8) Paragraph (7) of section 4975(e) is amended—

(A) by striking out "section 409A(h)" and inserting in lieu thereof "section 409(h)",

(B) by striking out "section 409A(e)(4)" and inserting in lieu thereof "section 409(e)(4)", and

(C) by striking out "section 409A(e)" and inserting in lieu thereof "section 409(e)".

(9) Paragraph (8) of section 4975(e) is amended by striking out "section 409A(l)" and inserting in lieu thereof "section 409(l)".

(10) Paragraphs (1) and (3) of section 6699(a) are each amended by striking out "section 409A" and inserting in lieu thereof "section 409".

(11) The table of sections for subpart A of part I of subchapter D of chapter 1 is amended by striking out "Sec. 409A" and inserting in lieu thereof "Sec. 409".

(e) EFFECTIVE DATES.—

(1) In general.—The amendments and repeals made by subsections (a), (b), and (c) shall apply to obligations issued after December 31, 1983.

(2) Subsection (d).—The amendments made by subsection (d) shall take effect on January 1, 1984.

(3) Bonds under qualified bond purchase plans may be redeemed at any time.—Notwithstanding—

(A) subparagraph (D) of section 405(b)(1) of the Internal Revenue Code of 1954 (as in effect before its repeal by this section), and

(B) the terms of any bond described in subsection (b) of such section 405,

such a bond may be redeemed at any time after the date of the enactment of this Act in the same manner as if the individual redeeming the bond had attained age 59½.

SEC. 902. REPEAL OF RULES RELATING TO GAINS FROM DISPOSITION OF PROPERTY USED IN FARMING WHERE FARM LOSSES OFFSET NONFARM INCOME.

(a) In General.—Section 1251 (relating to gain from disposition of property used in farming where farm losses offset nonfarm income) is hereby repealed.

(b) Technical and Conforming Amendments.—

(1) SECTION 170.—

(A) The second sentence of section 170(e)(1) (relating to certain contributions of ordinary income and capital gain property) is amended by striking out "1251(c),".

(B) Subparagraph (C) of section 170(e)(3) (relating to special rule for certain contributions of inventory and other property) is amended by striking out "1251,".

(2) SECTION 341.—Paragraph (12) of section 341(e) (relating to nonapplication of section 1245(a)) is amended by striking out "1251(c),".

(3) SECTION 453B.—The second sentence of section 453B(d)(2) (relating to liquidations to which section 337 applies) is amended by striking out "1251(c),".

(4) SECTION 751.—The second sentence of subsection (c) of section 751 (defining unrealized receivables) is amended—

(A) by striking out "farm recapture property (as defined in section 1251(e)(1)),", and

(B) by striking out "1251(c),".

(5) SECTION 1252.—The second sentence of section 1252(a)(1) (relating to gains from disposition of farm land) is amended by striking out ", except that

this section shall not apply to the extent section 1251 applies to such gain".

(c) CLERICAL AMENDMENT.—The table of sections for part IV of subchapter P of chapter 1 is amended by striking out the item relating to section 1251.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1983.

Mr. DORGAN [presiding]. The committee will come to order.

We are going to begin the committee hearing today in the absence of Chairman Rostenkowski, who is delayed at the airport. He will be with us in approximately a half hour. But we are going to expedite matters. I will read for the record a statement on behalf of the chairman.

Today, the committee will receive testimony on H.R. 3475, the Tax Law Simplification and Improvement Act of 1983. This legislation culminates months of effort by our congressional staff in identifying major problem areas in the law and developing proposed solutions in a collaborative process. The bill also contains a number of provisions which have been requested by the administration or suggested by others as needed improvements or simplifications to the structure of the tax law.

I wish to express my gratitude to those who have worked on preparing this bill as well as to the staff of the Treasury Department for their assistance and to those groups such as the American Bar Association and the American Institute of Certified Public Accountants that suggested areas for study, proposed solutions, and deliberated with our staff to develop the product that has been introduced by Mr. Conable and myself. We look forward to receiving additional recommendations today for improving the provisions of the bill during its consideration in the months ahead.

The primary importance of this measure is the attempt it represents to simplify some of the rules in the tax law which affect large numbers of average individual and business taxpayers. Unfortunately, the tax legislative process does not always provide an opportunity for necessary simplification efforts. I hope this current proposal will not be jeopardized by attracting nongermane amendments. In addition, I expect that every effort will be made to assure that this bill does not become a vehicle for broader or unrelated policy changes.

[Background information follows:]

BACKGROUND

H.R. 3475 contains nine titles, as follows (for a detailed technical explanation, see the Congressional Record of June 30, 1983, page H 4881):

Title I. Estimated tax revisions.—Title I contains a major and long overdue revision of the estimated tax provisions for individuals.

Title II. Domestic relations.—Title II includes revisions to the rules which govern the tax treatment of property transfers at divorce, alimony payments, and the dependency exemption for children of divorced parents as well as amendments to the so-called innocent spouse rules.

Title III. At-risk revision.—Title III represents an attempt to simplify and clarify the investment tax credit at-risk limitation added by the Economic Recovery Tax Act of 1981 [ERTA].

Title IV. Estate tax provisions.—Title IV contains two changes related to the estate tax provisions. One solves a long-standing difficulty related to charitable split interest transfers. Second, the law would be amended to better effectuate the original purpose of the alternate valuation provision of present law.

Title V. Foreign provisions.—Title V would make several changes in the present provisions affecting foreign taxpayers. One is a much needed definition of "resident alien." Several provisions are included to clarify and improve the foreign personal holding company rules. Code section 1248 would be amended to liberalize present law with regard to accumulated earnings and profits of a controlled foreign corporation [CFC]. This title also contains provisions to deal with a long-standing problem regarding so-called stapled stock.

Title VI. Miscellaneous Treasury administrative provisions.—Title VI contains a number of minor provisions recommended by the Department of the Treasury as changes that would simplify or improve their operations.

Title VII. Tax Court provisions.—Title VII includes several noncontroversial changes requested by the tax Tax Court, and a more substantive proposal designed to improve the representation of taxpayers involved in small cases before the Court.

Title VIII. Simplification of income credits.—Title VIII would simplify and rationalize the income tax credit provisions in the Internal Revenue Code. The credits would be grouped into logical categories and the various rules concerning limitations and carryovers would be conformed and simplified.

Title IX. Deadwood provisions.—Title IX repeals several obsolete provisions of the Internal Revenue Code.

Mr. DORGAN. Mr. Conable is recognized.

Mr. CONABLE. I have no statement, Mr. Chairman, but I do wish to express the hope that this will remain basically a revenue neutral bill. It is awfully easy to make assumptions about tax simplification which carry with them substantial revenue impacts. That was not our purpose. Whether or not simplification should go beyond this level technically, we are constantly in need of improving administrability of our tax system by making it more comprehensible and by phasing the technical requirements of the tax law in ways that will reduce the complications for those who have to live with the tax law.

I think it requires constant vigilance on our part to keep the revenue impacts from getting out of control and it is intended, however, to avoid that. It is going to be this member's intention anyway to try to prevent changes that could affect the fiscal policy of the Nation already in such serious difficulty.

Mr. DORGAN. Thank you, Mr. Conable.

Mr. Duncan?

Mr. DUNCAN. I have no questions, Mr. Chairman.

Mr. DORGAN. Thank you. Then we would like to call on the first witness. Again, Mr. Ron Pearlman, Deputy Assistant Secretary for Tax Policy.

And, Mr. Pearlman, welcome on your first appearance before the subcommittee.

STATEMENT OF RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. PEARLMAN. Thank you, Mr. Chairman, and members of the committee. I appreciate the opportunity to be here this morning to present the views of the Department on H.R. 3475. We are pleased to be here in support of the bill. We wish to compliment Mr. Rostenkowski and Mr. Conable for the efforts that have gone into developing the bill's simplification provisions. We all agree that the complexity in the tax laws is a burden on taxpayers, on the court system and on the administrators of the tax laws. Simplification, of course, is not an easy process, and we think that there are some positions taken in the bill with which we have disagreement and which I will attempt to identify this morning.

Before turning, however, to the technical provisions, I would like to emphasize, as Mr. Conable already has, that our support for this bill derives from our view that it would simplify our tax laws to a significant degree. The bill is not intended to increase Federal revenues and we understand that any revenue impact that the bill may have is purely incidental.

Indeed, we would support changes to the bill to make it revenue neutral, provided the changes would not reduce significantly the simplification that the bill seeks to achieve.

I want to emphasize that the views expressed in this testimony are those of the Treasury Department. The Office of Management and Budget has advised that timing considerations have prevented it from fully coordinating the needed review of this statement within the administration. Should the administration's position on any of the provisions of H.R. 3475 differ materially from the views contained in this testimony the committee will be notified promptly.

Title I deals with revision and simplification of estimated income tax for individuals. The most significant change in title I is to change the second estimated payment date from June 15 to July 15. There are two other changes that I would like to mention. One is a proposal to eliminate exception number (4) to the penalty for failure to pay estimated tax; that is, the exception based on last year's income, taxed at current year's rates. The second item is the proposal to give the Secretary authority for the first time to waive the penalty upon a showing of reasonable cause.

We are in support of title I but oppose the proposed change in the June 15 payment date. While we assume that the purpose for this change was to ease the burden of taxpayers who have to make an estimated payment only 2 months after the April 15 tax payment date, we think that estimated filers do get a substantial timing benefit in making payments much later than wage earners have to make payments of taxes, indeed, an average of 45 days longer than taxpayers whose liabilities are satisfied by withholding. Thus, there is no reason to increase this advantage by an additional 7 days by extending the payment to July 15.

We would note, also, that if we do move the payment date from June 15 to July 15 that this is likely to put additional pressure on the September 15 payment date, which, if extended, would push the third installment into the next fiscal year of the Federal Government and have a direct negative impact on the budget of approximately $10 billion.

We are in support of giving the Internal Revenue Service authority to waive the understatement penalty in extraordinary cases, but we recommend that the standard—and we really believe that this should be dealt with in the statute—applied to determine whether the penalty should be waived should be more stringent than the reasonable cause standard that is applied currently.

The underpayment of estimated tax penalty is in the nature of a nondeductible interest charge. That is, there is no interest paid on understated estimated payments. If the penalty is waived, therefore, the Government is going to collect no interest on underpayment of taxes.

We also question the value of eliminating the fourth exception to the imposition of the penalty which is applicable in the case of a taxpayer who pays an amount equal to the tax on the prior year's income tax at the current year's rate. This exception becomes particularly relevant where legislation is enacted that changes tax rates. We expect that in the event this penalty is not retained in the code, every time Congress does change tax rates it will simply re-enact this exception and we really question whether that is desirable.

Title II of the bill deals with several provisions aimed at taxation of matters arising in connection with domestic relations. Under present law, by reason of the Supreme Court's decision in *United States* v. *Davis,* a transfer of appreciated property to a spouse—or former spouse—in exchange for the release of marital claims results in the recognition of gain to the transferor. The spouse receiving the property takes a basis in the property received equal to its fair market value at the time of receipt. The bill would overrule the result in the *Davis* case by providing that a transfer of property to a former spouse incident to a divorce would be treated, for income tax purposes, as a gift.

Under the bill no gain or loss would be recognized to the transferor and the transferee would take the transferor's basis in the property. A transfer would be treated as "incident to divorce" if it occurs within 1 year after the termination of the marriage or is "related to the cessation of the marriage."

It should be noted that the bill does more than overrule the *Davis* case. The nonrecognition of gain and carryover basis provisions of the bill apply to all transfers of property incident to divorce, whether or not made in exchange for the release of marital claims, and apply to all transfers of property between spouses during the marriage, whether or not incident to divorce, and whether or not the transfer was made for consideration.

Treasury supports this section of the bill. When applied to a transferor, the *Davis* rule may produce harsh consequences, often placing a tax burden on top of heavy alimony and support obligations. The result can be particularly harsh if the effect of the *Davis* rule is not anticipated in arriving at the divorce settlement. For example, the parties to a divorce may view all property acquired during the marriage as jointly owned, even if the bulk of the property is held in the husband's name. An equal division of such property would trigger recognition of gain under *Davis*. Of course, residents of community property States are largely free from the effects of *Davis* since the parties have equal ownership rights in the marital property.

We also are concerned that, in many cases, the *Davis* rule may be used to the Government's detriment. Often, a transferor of appreciated property incident to a divorce will not report any gain on the transaction, either through intentional evasion or unawareness of the *Davis* rule. When the recipient spouse sells the property, however, he is entitled under *Davis* to compute his gain or loss by reference to a basis equal to the fair market value of the property at the time received. In these circumstances, the Government will be whipsawed by the *Davis* rule.

The second item deals with the tax treatment of alimony and separate maintenance. This section would make a number of changes in the tax treatment of alimony payments. Under present law amounts which constitute alimony are included in the income of the recipient spouse and are deducted by the payor spouse. The principal thrust of the bill would be to change the definition of alimony in a number of important ways. We are in agreement with a number of the provisions in the alimony section of the bill because they would provide more objective standards for denying alimony treatment to transfers which are essentially part of a nondeductible property settlement.

We oppose, however, the complete elimination of the periodic payment requirement and 10-year rule requirement presently contained in the code. While the precise application of these requirements has generated a fair amount of controversy in the past, they do remain as important safeguards for preventing nondeductible property settlements from being treated as alimony.

We think much of the prior law complexity and uncertainty could be resolved without eliminating these provisions. To this end, we think they may be modified in several ways. First, for reasons discussed more fully below, the 10-year period should be shortened to 5 years.

Second, the 5-year period should begin on the date when the first payment is made. This change would end the long series of controversies regarding the effective date of the divorce decree.

Third, the 5-year rule could provide that any series of payments which, by the terms of the governing document, will last for a period of less than 5 years will not be considered periodic, even if subject to a contingency. Thus, under the proposed change, a series of monthly payments to last for 4 years or until the remarriage of the recipient, whichever is earlier, would not be treated as periodic. This rule, however, would not necessarily require that payments be made for more than 5 years. Thus, payments to last until remarriage or death of the former spouse, whichever is earlier, would be treated as alimony since the period for the payments might extend more than 5 years.

This change, of course, would eliminate the "contingency" rule now contained in Treasury regulation section 1.71-1(d)(3). Under this rule, payments extending over a period of less than 10 years are considered "periodic," in spite of the 10-year rule, if they *(a)* are "subject to any one or more of the contingencies of death of either spouse, remarriage of the wife, or change in the economic status of either spouse" and *(b)* are "in the nature of alimony or an allowance for support."

Retention of this highly subjective test would run counter to the general thrust of the bill and, in effect, would reintroduce the "marital obligation" test which the bill would eliminate. Furthermore, we are concerned that this rule treats as alimony amounts paid over a relatively short period of time during which the specified contingency is remote. Finally, the scope of the present contingency rule is unclear as the regulations specify that the required contingency may be one imposed by local law, as well as one specified in the decree, instrument, or agreement. Our proposal would eliminate this uncertainty.

We recognize that eliminating the contingency rule might have the effect of denying alimony treatment to some series of payments made over a relatively short period, even where the payments are intended for the support of the recipient spouse. We believe these situations will be rare, however, because the proposed rules would be readily understandable by the parties. Nevertheless, to reduce the cases in which the rules might operate in an unintended way, we suggest that the 10-year rule be shortened to a 5-year rule—with a maximum deduction in each year of 20 percent of the total amount of the payments. While we recognize that support payments lasting less than 5 years would not be deductible, in our view any slight disadvantage from that result would be more than offset by the simplicity and certainty that the proposed system would provide.

We also believe this proposed approach is preferable to the rule of the bill requiring that it be "reasonable to expect" that at least one-half of the amounts payable in a series will be paid more than 1 year after the first payment. In effect, this reduces the 10-year period to 2 years. We are concerned that such a short time requirement does not provide a meaningful safeguard. Moreover, we are uncertain as to how the "reasonable to expect" test would apply in a case involving a remarriage contingency. For example, would a series of payments be treated as alimony if $10,000 were paid in the first year and $1,500 in each succeeding year until death or remarriage of the recipient? Such a subjective test may reintroduce much of the uncertainty the bill attempts to eliminate.

We strongly support the information reporting requirements proposed in this section of the bill, which would facilitate the matching of returns by the IRS.

The next portion of the domestic relations provisions deals with the dependency exemption. Under present law the $1,000 dependency exemption for a child of divorced parents may be claimed by the noncustodial parent if the divorce decree allocates the exemption to him and he provides more than $600 of support for the child, or if he provides more than $1,200 of support and the custodial parent cannot show that he—custodial parent—provided more than one-half of the support for the child. If neither of these support tests is met, the exemption is allocated to the custodial parent.

The bill would eliminate the support tests of present law for allocating the dependency exemption between divorced parents and would simply allocate the dependency exemption to the custodial parent. The custodial parent would be the parent having custody of the child for the greater portion of the calendar year. The only time the noncustodial parent would be entitled to the exemption would be where the custodial parent relinguishes the right to claim the dependency exemption in a written declaration which the noncustodial parent would be required to attach to his return. The bill also would permit each spouse to deduct amounts he pays for medical expenses of the child.

We strongly support this portion of the bill. We are advised that 20 percent of the so-called S cases presently pending in the Tax Court involve the dependency exemption. The bill proposes a rule which is both simple and fair and while it would not eliminate all controversy in this area we believe it would mean most controversies would be easily resolved by referring to the divorce or separation agreement.

The next item deals with the innocent spouse provision of the code. Under the current code there are limited circumstances under which a spouse can be relieved for liability of tax, interest and penalties with respect to joint return. The bill would expand the innocent spouse rule in several respects. While we agree that some additional relief should be available to innocent spouses, we oppose the specific provisions of section 205 of the bill. We recommend that a more limited relief provision be enacted.

When a joint return is filed, both spouses must sign the return, thereby swearing to the truth of the statements contained therein under penalty of perjury. Both spouses are jointly and severally liable with respect to any tax due. The innocent spouse rule provides a very limited exception to the joint and several liability, designed to cover the situation where an individual receives a substantial amount of income which he conceals from both his spouse and the Government.

Relief from liability is available only where the innocent spouse can show that (*a*) he did not know and had no reason to know of the income, (*b*) that he received no significant benefit from the concealed income, and (*c*) that it would be inequitable to hold him liable for the underpayment of tax resulting from the failure to report such income.

We are troubled by the bill's significant expansion of this relief provision. We recognize that on a complex tax return it may be easy for one spouse to conceal a fraudulent deduction or credit item from the other spouse. Nevertheless, these items are fundamentally different from an omission of gross income in that they appear on the face of the joint return. In addition, the benefit of the reduced tax liability that results from an unjustified deduction or credit arguably inures to the benefit of both spouses. Perhaps in recognition of this distinction the bill also removes the significant benefit test.

Without the significant benefit test a major safeguard is removed from the system. We recognize the argument that the significant benefit test is unnecessary in light of the general provision of the bill that relief is available only if, taking into account all facts and circumstances, it is inequitable to hold the spouse liable for the deficiency in tax. This argument might eventually prove to be true, but for the foreseeable future we would expect to see the claim for innocent spouse relief interposed in virtually every case where the IRS attempted to collect from one spouse who signed a joint return an underpayment of tax attributable to the other spouse. The increased availability of the claim for innocent spouse relief would lead to additional litigation and administrative costs. The expansion of the rule to cover any underpayment of tax in excess of $500 or 10 percent of the proper amount of tax substantially exacerbates this problem.

In spite of our opposition to this provision of the bill for the reasons given above, we are sympathetic to those taxpayers who are being held responsible for tax liability resulting from the misdeeds of a spouse or, more often, a former spouse. We suggest the way to deal with this provision is to relax the Service's ability to waive penalties in the case of the innocent spouse.

I would like now to turn to title III of the bill dealing with the at risk rules. Section 301 of the bill makes a number of technical changes to the at risk limitation but retains the general principles of the general rules. The principal substantive change involves revision of the investment credit at risk limitation.

Section 301 would make a number of technical changes to the present investment credit at-risk limitation, but retain the general principles of the present rules. The principal substantive change involves application of the investment credit at-risk limitation to shareholders of S corporations. The bill would clarify that the determination of the extent to which a shareholder in an S corporation—as well as a partner in a partnership—is at risk is to be made at the shareholder or partner level.

An exception is provided for the proceeds of certain third party—nonseller—recourse loans to an S corporation. These loans are considered to create amounts at risk with respect to the shareholders if: One, the property financed by the loans is used in connection with the active conduct of a trade or business, and two the corporation has at least three full-time employees whose work directly relates to the trade or business.

We think the problems addressed by section 301 of the bill deserve attention. However, we oppose the approach taken to solve these problems. Section 301 represents a narrow, piecemeal solution to a few technical problems in the present statute and in our opinion does not go far enough toward making the statute workable. As pointed out in the Joint Committee description of H.R. 3475, the investment credit limitation is in large part designed to prevent abuses arising from overvaluation of property through the use of nonrecourse financing through passive tax shelter activities.

The possibility of abuse is greatest in the case of nonrecourse financing provided by persons such as sellers. We think it has little likelihood of abuse where the financing comes from unrelated third party lenders who can only look to the value of the property as security for the debt. For these reasons we would prefer to see a more complete revision of the investment credit at-risk provisions which would be directed to preventing these overvaluation abuses.

The at-risk limitation on the deductibility of losses under code section 465 presents a similar problem with respect to active businesses. H.R. 883, a bill introduced by Representative Pickle, would allow a closely held subchapter C corporation that is engaged in an active business and which meets certain other requirements to use nonrecourse financing without becoming subject to the at-risk limitation on losses. We support the general approach taken in H.R. 883 and would support expanding H.R. 3475 to cover those situations. To the extent that the present at-risk rules frustrate legitimate business transactions or impose unnecessary limitations on taxpayers, relief should be provided.

However, we believe the comprehensive reworking of both the investment credit and loss limitation rules would be desirable at this time, and we would be happy to work with the committee to that end.

Title IV contains several estate tax provisions. The first would provide a permanent rule allowing for the reformation of defective charitable trust instruments that must conform with the Tax Reform Act of 1969. We support the enactment of a permanent rule that will allow reformation of these instruments. We would point out that there are a number of related issues which we think should be dealt with in this section, and they are detailed in our written statement.

The second item deals with an effort to limit the alternate valuation date rule applicable in the case of the Federal estate taxes to situations where there have been reductions in the gross estate and estate tax. We believe that this was the intention of the legislation when the alternate valuation provision was originally enacted and we are supportive of section 402 of the bill which would make the election available only in that limited circumstance.

Title V of the bill contains a number of provisions dealing with the foreign provisions of the code. We support each of these proposals. I intend to mention only a couple of them. The first one being section 501 that includes for the first time in the statute definitions of the terms resident alien and nonresident alien. The status of an alien under the U.S. tax laws as either a resident or nonresident alien is very important in making a determination of the manner in which that alien is taxed for U.S. tax purposes.

We think it therefore highly desirable to provide more precise, easily applied and objective standards of residency. The remainder of the provisions in title V for the most part make technical changes in the bill. Certain of these are clarifying in nature and others correct technical problems that have been brought to the attention of both Treasury and the committee staff. We strongly support these changes.

I want to mention one of them. That is section 506 dealing with stapled stock. A stapled stock transaction is a technique whereby there is an attempt to prevent, for example, the controlled foreign corporation or boycott provisions of the code from applying to a foreign subsidiary of the U.S. parent corporation. Stapled stock transactions have also been utilized by domestic corporations in efforts to avoid the rules relating to the prevention of multiple rate bracket amounts with respect to controlled groups, and in efforts to avoid the prerequisites for treatment as a real estate investment trust or regulated investment company where the company wishes to engage in nonqualifying activities. Although the precise mechanism for the structure may be different than in the foreign area, the intended result is the same—keeping effective control of the subsidiary in the same hands while avoiding various restrictions or limitations that would apply if the subsidiary were owned directly by the parent corporation.

Section 506 of the bill would curtail the use of stapled stock transactions for tax avoidance purposes. The bill would provide generally that where a foreign and a domestic corporation are stapled entities, the foreign corporation would be treated as domestic. The bill also would provide rules governing stapled stock of domestic corporations. For example, all stapled entities would be treated as one in determining whether anyone is a REIT or RIC. The Secretary could modify these rules by regulation and prescribe such other rules by regulation as would be necessary to prevent tax avoidance. We are pleased that this issue is addressed in the bill and with the flexibility granted to deal with the many issues arising from such transactions.

I also wish to note with approval the provision deferring the effect of the amendment with respect to pre-existing stapled stock arrangements until January 1, 1985. This deferral would give those companies having existing stapled stock arrangements sufficient time to unwind those arrangements, if they so desire.

Title VI contains a number of provisions designed to improve the administration of the Department of the Treasury. We commend the committee for recognizing that it is important for the Department to be administered efficiently and strongly support this title of the bill. I wish to mention only two of these provisions.

The first is contained in section 602 and deals with the removal of the $1 million limitation on the Treasury Department's working capital fund. At present the working capital fund ceiling is $1 million. It is designed for the financing of centralized Department-wide printing and telecommunications services. The bill would eliminate the $1 million ceiling which was set in 1970 when the fund was established. I should point out that this has no budgetary impact.

The other item I would like to mention is an additional provision we propose. I refer to it as proposed section 607. It would remove the $1 million limitation on the Secretary's special authority to dispose of obligations. Under present law the Secretary has authority, outside of the context of the Federal Property and Administrative Services Act of 1949, to dispose of obligations acquired by the Secretary for the United States or transferred to the Secretary by an executive agency. The Secretary also may make arrangements to extend the maturity of such obligations.

The Secretary is authorized to dispose of or extend the maturity of obligations "in the way, in amounts, at prices, and on conditions the Secretary considers advisable and in the public interest."

The provision has been in effect since 1945, and was designed, in part, to allow for the expeditious disposition of obligations without market disruption and loss that might result from lengthy disposal procedures. Since the section was enacted in 1945, it has contained a limitation of $1 million on the maximum par value of obligations of one issuer that could be held for such disposition. If no-par obligations are involved, the $1 million limitation applies to the stated or book value of such obligations.

Because of changes in both the capitalization of entities in which the United States has acquired an interest (most frequently as a result of claims in bankruptcy) and inflation, this $1 million limitation restricts the ability of the Secretary to obtain the best value for the United States in disposition transactions. We strongly recommend that limitation be repealed as part of this larger legislative action to improve the efficient operation of the Department.

Title VII has a number of provisions dealing with the Tax Court. The Treasury Department endorses these provisions. We believe they would help make the Tax Court proceedings more efficient and fairer to taxpayers.

In general, we believe that the Tax Court is best able to decide who should be entitled to practice before it. Thus, we recommend that the committee consider amending the bill to grant this authority to the court. Certainly, the committee should give serious consideration to the testimony that will be given by the Tax Court on this subject.

Title VIII deals with an effort to simplify the income tax credits in the code. Within certain limits, present law provides for various nonrefundable personal and business tax credits against a taxpayer's tax liability. The relative availability of a particular credit may be the product of numerous factors: the priority of the credit in the order of application, the nature of the limit—if any—imposed on the credit allowed for a particular year, whether carrybacks or carryforwards of the unused portion of a credit are available, and the order in which carrybacks, carryforwards, and current year credits are allowed.

The credits under present law have been enacted on a piecemeal basis. Thus, different rules govern the availability of each credit, with the result that the interaction among the various rules is not only complex, but often illogical.

Title VIII of the bill proposes to group these credits into three separate groupings. We think the groupings will make the credits less complex and more rational. I want to make a reference only to the third category of credits. They are the business credits, namely, the investment credit, jobs credit, alcohol fuel credit, research activities credit, and ESOP credit. These credits which today are governed by separate limits and rules would be combined into a single business credit subject to a single aggregate limitation on taxes against which they can be applied and to a single set of carryback and carryforward rules.

The bill would repeal the different limitations applicable to the separate business credits under present law and impose on the combined business credit the same limitation that presently applies to the investment tax credit; namely, 100 percent of the first $25,000 in liability and 85 percent of the excess.

The Treasury Department generally supports the provisions of title VIII but strongly opposes the provision of the bill that reduces the amount of tax liability that may be offset by the research activities credit. The bill would rationalize the rules governing and the relationships among the credits in a way that would eliminate much of the complexity and inconsistency in the provisions.

It is not clear to us at this time whether or not the extension of the 85 percent of tax liability limitation under the bill would represent a significant reduction in the availability of the business credits. We are going to continue to analyze the revenue impact of this provision of the bill. But I wish to re-emphasize at this point that we will oppose any provision which reduces the effectiveness of the research activities credit.

I would like to move now to suggest three fairly minor additional proposals that we suggest would simplify and improve the administration of the tax laws, and which we think are consistent with the chairman's statement and with the spirit of this bill. They are detailed in my statement.

I do not intend to go into detail with them now, but simply to mention them. First would be an amendment to section 6501 of the code which would extend the period during which the Internal Revenue Service could assess a tax beyond the 3-year period presently contained in the statute. At the present time present law does not permit the assessment of a tax after the 3-year period has expired.

Thus, if a taxpayer waits until the end of the 3-year period to file an amended return, and show an additional tax, the Internal Revenue Service may not have enough time before the expiration of the three year-period in which to assess that tax. We think the statute should be amended to give the Internal Revneue Service at least 60 days from the time of the filing of the amended return during which the assessment can be made.

This change would assure that the additional tax due as reported by the taxpayer could in fact be assessed and collected.

Our second change would propose that section 6311 of the code be amended to permit the Internal Revenue Service to accept checks issued by mutual savings banks, credit unions, and savings and loan associations so that a general tax lien would inure to the benefit of the United States. It would then be possible for the Internal Revenue Service to give a rapid release of a tax lien to a taxpayer.

Finally, we recommend that the code be amended to authorize disclosure of windfall profit tax information to States. Currently the statute does authorize the disclosure to States of information relating to a number of taxes and we think that the statute should be amended so that the IRS can also provide information regarding the windfall profit tax to the State agencies.

I wish to thank the committee for giving the Treasury Department the opportunity to present its views on H.R. 3475. We look forward to working with you and your staff to further simplify our tax laws. I would be pleased to answer any questions the committee might have on this testimony.

[The prepared statement follows:]

Statement of Ronald A. Pearlman, Deputy Assistant Secretary (Tax Policy), Department of the Treasury

Mr. Chairman and members of the committee: I am pleased to have the opportunity to present the views of the Treasury Department on H.R. 3475, the Tax Law Simplification and Improvement Act of 1983.

In general, we support the bill. I wish to compliment the sponsors of H.R. 3475 for the efforts that have gone into developing the bill's simplification provisions. I believe all would agree that the present complexity of our tax laws imposes an undue burden on taxpayers, our court system and those who must administer those laws. However, simplification is not an easy process, and we disagree with the approaches taken in several of the bill's substantive provisions. I will discuss each of the provisions of the bill in turn.

Before turning to the technical provisions of the bill, I would like to emphasize that our support for this bill derives from our view that it would simplify our tax laws to a significant degree. The bill is not intended to increase Federal revenues and we understand that any revenue impact that the bill may have is purely incidental. Indeed, we would support changes to the bill to make it revenue-neutral, provided the changes would not reduce significantly the simplification that the bill seeks to achieve.

I want to emphasize that the views expressed in this testimony are those of the Treasury Department. The Office of Management and Budget has advised that timing considerations have prevented it from fully coordinating the needed review of this statement within the Administration. Should the Administration's position on any of the provisions of H.R. 3475 differ materially from the views contained in this testimony the Committee will be notified promptly.

TITLE I—REVISION AND SIMPLIFICATION OF ESTIMATED INCOME TAX FOR INDIVIDUALS

Sections 101-103: Revision of Penalty for Failure To Pay Estimated Income Tax and Repeal of Requirement of Declarations

Present law

Individuals are required to pay estimated tax on income that is not subject to withholding in four installments on the following dates: April 15, June 15, September 15 and January 15. Generally, individuals are subject to an addition to tax computed as a nondeductible interest charge for any underpayment of estimated tax for the period of such underpayment. The amount of the underpayment for any installment is the excess of 20 percent of the taxpayer's tax liability for the current year over the amount of the actual payment. The period of underpayment begins on the due date of the installment payment and ends on the earlier of either the following April 15 or the date the underpayment is paid.

No penalty for underpayment of estimated tax is imposed if any one of the following exceptions is met:

(1) total payments of estimated tax equal or exceed the amount shown as tax on the preceding year's return;

(2) total estimated tax payments equal or exceed 80 percent of the tax which would be due if the income already received during the current year were placed on an annualized basis;

(3) total tax payments equal or exceed 90 percent of the tax which would be due on the income actually received from the beginning of the year to the end of the month before the month the installment was due as if such months constituted the taxable year;

(4) total tax payments equal or exceed the tax based on the facts shown on the return for, and the law applicable to, the prior year's return, but computed under the current year's tax rates and exemptions;

(5) taxpayer had no tax liability for the preceding year and was a U.S. citizen or resident for such year;

(6) the tax due, after credits, is less than $300 in 1983, $400 in 1984 and $500 in 1985 and thereafter.

The latter two exceptions were enacted in 1982 and 1981, respectively.

Description of provisions

Sections 101 and 102 of the bill attempt to consolidate and clarify the rules governing payments of estimated tax by individuals. These provisions of the bill also make a number of substantive changes to those rules.

The bill would change the June 15 payment date to July 15. In addition, the bill would define the amount of an underpayment as the excess of the required installment over the amount actually paid on or before the installment payment date. The required installment is defined generally as 25 percent of the lesser of (1) 80 percent of the tax shown on the return for the taxable year or (2) 100 percent of the tax for the prior year. However, if the required payment computed on an annualized income basis is less than either amount determined pursuant to the preceding sentence, then the required installment is this lesser amount. In determining the appropriate installment payment based on the prior year's return, adjustments to that return resulting from mathematical errors and amended returns are to be taken into account.

Finally, the bill would make several changes to the current exceptions to the imposition of the underpayment penalty. The exception based on 90 percent of the current year's income to date (exception 3) and the exception based on last year's income at the current year's rates (exception 4) would be repealed. However, the Secretary would be granted authority to waive the underpayment penalty when the underpayment is due to reasonable cause and not to willful neglect.

The proposed changes would be effective for taxable years beginning after December 31, 1983.

Discussion

We support Title I of H.R. 3475 insofar as it consolidates and clarifies the rules of current law. We oppose certain of the substantive changes proposed by the bill.

We oppose the proposed change in the June 15 payment date. The change apparently is intended to ease the burden on taxpayers who have to make an estimated tax payment only two months after paying their regular tax liability on April 15. However, taxpayers who satisfy their income tax liability by making estimated tax payments enjoy a substantial advantage over taxpayers whose income is subject to withholding. Taxes on income subject to withholding are paid at the time the income is received. Taxes on other income are paid pursuant to the estimated tax system near the end of each calendar quarter. Thus, taxpayers who satisfy their tax liability by making estimated tax payments enjoy the of those funds for an average of 45 days longer than taxpayers whose liabilities are satisfied by withholding. We see no reason why this advantage should be increased an additional 7 days by extending the June 15 payment date until July 15.

Moreover, a change in the June 15 payments date would leave only a two month period between the installment payment due July 15 and the one due September 15. This change would increase the pressure to change the September 15 date to October 15. Because this later change would move the installment into the Federal Government's next fiscal year, it would have at direct negative effect on the budget of approximately $10 billion in the year of change.

In general, we support giving the IRS the authority to waive the underpayment penalty in extraordinary cases. we recommend, however, that the standard to be applied in determining whether a penalty should be waived, should be one that is more stringent than the reasonable cause standard that is applied currently to other penalties imposed by the Code. The underpayment of estimated tax penalty is in the nature of a nondeductible interest charge. If the penalty is waived, the Government will not collect any interest on the underpayment of estimated taxes.

Moreover, we believe that the other exceptions to the imposition of the penalty and the fact that taxpayers need only pay 80 percent of their tax liability in order to avoid a penalty generally are sufficient to absolve any taxpayer who makes a good faith effort to comply with the law.

Most of the hardship cases that have arisen in the past would be moot under the present statutory scheme. Many of them will fall within the exception enacted in 1981 and 1982 which provide relief where either the current year's tax liability is small or where there was no tax liability for the prior year. Many others will be rendered moot by a 1982 change in the withholding laws which requires withholding on pension benefits. Prior to this latter change, taxpayers who had satisfied their tax liability through wage withholding all their working lives and who were unaware of the estimated tax found themselves, upon retirement, subject to a penalty for failure to comply with those provisions with respected to their retirement income. The fact that pension benefits are now subject to withholding eliminates this problem.

A further concern with the reasonable cause standard is that its vagueness might lead taxpayers to request reasonable cause relief on a variety of grounds which Congress never contemplated. This could place an enormous administrative burden on the IRS, and may lead to increased litigation and uncertainty.

We also question the value of eliminating the exception to the imposition of the penalty in the case of a taxpayer who pays an amount equal to the tax on the prior year's income at the current year's rates. This exception is relevant in a year in which a tax rate increase or decrease goes into effect and was enacted to provide taxpayers with the certainty of being able to rely on the prior year's income figures in computing their tax liability under the new rates. We believe this exception should be retained for those occasional years in which it becomes relevant and predict that if it is not, Congress will enact such an exception for any year in which a rate change becomes effective.

TITLE II—DOMESTIC RELATIONS

Section 202: Treatment of Transfers of Property Between Spouses or Incident to Divorce

Description of provisions

Under present law, a transfer of appreciated property to a spouse (or former spouse) in exchange for the release of marital claims results in the recognition of gain to the transferor. *United States* v. *Davis,* 370 U.S. 65 (1962). The spouse receiving the property takes a basis in the property received equal to its fair market value at the time of receipt. The bill would overrule the result in the *Davis* case by providing that a transfer of property to a former spouse incident to a divorce would be treated, for income tax purposes, as a gift. Under the bill, no gain or loss would be recognized to the transferor and the transferee would take the transferor's basis in the property. A transfer would be treated as "incident to divorce" if it occurs within one year after the termination of the marriage or is "related to the cessation of the marriage."

It should be noted that the bill does more than overrule the *Davis* case. The nonrecognition of gain and carryover basis provisions of the bill apply to all transfers of property incident to divorce, whether or not made in exchange for the release of marital claims, and apply to all transfers of property between spouses during the marriage, whether or not incident to divorce, and whether or not the transfer was made for consideration.

Discussion

Treasury supports this section of the bill. When applied to a transferor, the *Davis* rule may produce harsh consequences, often placing a tax burden on top of heavy alimony and support obligations. The result can be particuarly harsh if the effect of the *Davis* rule is not anticipated in arriving at the divorce settlement. For example, the parties to a divorce may view all property acquired during the marriage as jointly owned, even if the bulk of the property is held in the husband's name. An equal division of such property would trigger recognition of gain under *Davis*. Of course, residents of community property states are largely free from the effects of *Davis* since the parties have equal ownership rights in the marital property.

We also are concerned that, in many cases, the *Davis* rule may be used to the Government's detriment. Often, a transferor of appreciated property incident to a divorce will not report any gain on the transaction, either through intentional evasion or unawareness of the *Davis* rule. When the recipient spouse sells the property, however, he is entitled under *Davis* to compute his gain or loss by reference to a basis equal to the fair market value of the property at the time received. In these circumstances, the Government will be whispsawed by the *Davis* rule.

We also support the mandatory nonrecognition treatment for all transfers between spouses and all transfers incident to divorce. The unlimited marital gift tax deduction already permits these transfers to be made free of tax during the marriage where they are properly characterized as donative transfers. Moreover, while there occasionally may be arm's-length sales between spouses or incident to divorce, these sales are very rare, and we do not anticipate any significant revenue loss from the board, simple rule contained in the bill.

Section 203: Tax Treatment of Alimony and Separate Maintenance Payments

Description of provisions

This section of the bill would make a number of changes in the tax treatment of alimony payments. Under present law, amounts which constitute alimony are included in the income of the recipient spouse and are deducted by the paying spouse. The principal thrust of the bill would be to change the definition of alimony in a number of important ways:

(1) The bill would eliminate the rule that, in order to be treated as alimony, a payment must be "in discharge of a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the" payor spouse.

(2) Only payments in cash could qualify as alimony.

(3) Alimony would not include any payment made in exchange for a transfer of property by the payee spouse.

(4) A payment obligation which does not terminate upon the death of the payee spouse could not be deducted as alimony.

(5) The "periodic payment" test of section 71(a) and the "10-year rule" of section 71(c) would be replaced with a rule that, in order to be treated as alimony, a payment must be one of a series of payments where it is reasonable to expect that at least 50% of the amount payable would be paid more than one year after the date on which the first payment is made. This rule would not apply to isolated payments ordered by a court in a decree subsequent to the divorce decree.

(6) No payment could be treated as alimony if the parties were members of the same household at the time of the payment.

(7) At the election of the parties, any payment which would otherwise constitute alimony could be excluded from the recipient spouse's income and not deducted by the payor.

(8) Under regulations to be issued, the recipient of alimony could be required to report his taxpayer identification number to the payor and the payor could be required to report such number on the tax return for the year in which the payment is made. A $50 penalty could be imposed for failure to comply with the requirements.

Discussion

Under a statutory scheme which taxes alimony payments to the recipient and grants a corollary deduction to the payor, the definition of alimony must attempt to reconcile competing considerations. First, the definition should attempt to exclude payments which are not made for the support of the recipient spouse. The principal categories of payments that should be excluded are gifts, payments made for child support, and payments which represent divisions or reallocations of property owned by the spouses. If these payments were deductible, parties to a divorce would have not restrictions upon their ability to maximize tax savings by shifting income from higher to lower tax bracket taxpayers. It is asserted by some that it is desirable to give this flexibility to parties to a divorce.

We are very concerned about expanding the definition of deductible alimony payments in such an uncontrolled way. These payments have not been deductible in the past, and we believe there is a perception among taxpayers that they should not be deductible. A system which allows a deduction for these type of payments to a divorced spouse, therefore, might be perceived as unfair, especially by single and married taxpayers, since they are not allowed a deduction for amounts they spend to support their children or for gifts to their spouses or children. In addition, we believe significant revenue losses might result from permitting the deduction of these payments notwithstanding that in most cases the amounts will be fully taxed to the recipient spouse.

The competing consideration is that the definition of alimony should provide clear, objective standards by which the parties can understand the tax consequences of their divorce settlement and make their plans accordingly. This factor is especially important since divorce is such a common occurrence and frequently involves parties who have little knowledge of the tax concept of alimony and who cannot afford sophisticated tax counsel.

Present law gives undue weight to the first consideration by limiting alimony to payment made in discharge of a legal obligation arising out of the marital or family relationship. This standard, which necessarily depends on all of the facts and circumstances relating to the divorce settlement, has resulted in a great deal of litigation and, in many cases, denies certainty to the parties in planning their divorce settlement. We support the elimination of this test from definition of alimony and its replacement with tests which are more objective.

Thus, we support those provisions of the bill which (1) limit alimony to cash payments, (2) deny alimony treatment to payments which do not terminate upon the death of the recipient spouse, and (3) permit the parties to elect to exclude from the recipient spouse's income and treat as nondeductible by the payor any payment which otherwise would constitute alimony. All three of these rules provide objective standards for denying alimony treatment to transfers which are essentially part of a nondeductible property settlement. While the denial of alimony treatment for payments made in exchange for property may create some complexity in certain cases, we believe that such a rule is necessary, especially since the overruling of the *Davis* case will facilitate property transfers between spouses. It should be made clear that a relinquishment of marital or support rights would not be considered property exchanged by a spouse for purposes of this rule.

We oppose, however, the complete elimination of the periodic payment requirement and the 10-year rule. While the precise application of these requirements has generated a fair amount of litigation, they remain important safeguards for preventing nondeductible property settlements from being treated as alimony. These safeguards becomes even more important if the requirement that the payment be one made in satisfaction of a "marital obligation" is eliminated.

We believe that much of the complexity and uncertainty in the application of the periodic payment test and the 10-year rule can be reduced without eliminating these provisions. To this end, we think that they might be modified in several ways. First, for reasons discussed more fully below, the 10-year period should be shortened to 5 years.

Second, the 5-year period should begin on the date when the first payment is made. This change would end the long series of conroversies regarding the effective date of the divorce decree.

Third, the 5-year rule could provide that any series of payments which, by the terms of the governing document, will last for a period of less than 5 years will not be considered periodic, even if subject to a contingency. Thus, under the proposed change, a series of monthly payments to last for 4 years or until the remarriage of the recipent, whichever is earlier, would not be treated as periodic. This rule, however, would not necessarily require that payments be made for more than 5 years. Thus, payments to last until remarriage or death of the former spouse, whichever is earlier, would be treated as alimony since the period of the payments might extend more than 5 years.

This change, of course, would eliminate the "contingency" rule, now contained in Treasury Regulation section 1.71-1(d)(3). Under this rule, payments extending over a period of less than 10 years are considered "periodic," in spite of the 10-year rule, if they (a) are "subject to any one or more of the contingencies of death of either spuse, remarriage of the wife, or change in the economic status of either spouse" and (b) are "in the nature of alimony or an allowance for support." Retention of this highly subjective test would run counter to the general thrust of the bill and, in effect, would reintroduce the "marital obligation" test which the bill would eliminate. Furthermore, we are concerned that this rule treats as alimony amounts paid over a relatively short period of time during which the specified contingency is remote. Finally, the scope of the present contingency rule is unclear as the regulations specify that the required contingency may be one imposed by local law, as well as one specified in the decree, instrument, or agreement. Our proposal would eliminate this uncertainty.

We recognize that eliminating the contingency rule might have the effect of denying alimony treatment ot some series of payments made over a relatively short period, even where the payments are intended for the support of the recipient spouse. We believe these situations will be rare, however, because the proposed rules would be readily understandable by the parties. Nevertheless, to reduce the cases in which the rules might operate in an unintended way, we suggest that the 10-year rule be shortened to a 5-year rule (with a maximum deduction in each year of 20 percent of the total amount of the payments). While we recognize that support payments lasting less than 5 years would not be deductible, in our view any slight disadvantage from that result would be more than offset by the simplicity and certainty that the proposed system would provide.

We also believe this proposed approach is preferable to the rule of the bill requiring that it be "reasonable to expect" that at least one-half of the amounts payable in a series will be paid more than one year after the first payment. In effect, this reduces the 10-year period to 2 years. We are concerned that such a short time requirement does not provide a meaningful safeguard. Moreover, we are uncertain as to how the "reasonable to expect" test would apply in a case involving a remarriage contingency. For example, would a series of payments be treated as alimony if $10,000 were paid in the first year and $1,500 in each succeeding year until death or remarriage of the recipient? Such a subjective test may reintroduce much of the uncertainty the bill attempts to eliminate.

We strongly support the information reporting requirements proposed in this section of the bill, which would facilitate the matching of returns by the IRS.

Section 204: Dependency Exemption In the Case of Child of Divorced Parents, Etc.

Description of provisions

Under present law, the $1,000 dependency exemption for a child of divorced parents may be claimed by the noncustodial parent if the divorce decree allocates the exemption to him and he provides more than $600 of support for the child, or if he provides more than $1,200 of support and the custodial parent cannot show that he (custodial parent) provided more than one-half of the support for the child. If neither of these support tests is met, the exemption is allocated to the custodial parent.

The bill would eliminate the support tests of present law for allocating the dependency exemption between divorced parents and would simply allocate the dependency exemption to the custodial parent. The custodial parent would be the parent having custody of the child for the greater portion of the calendar year. The only time the noncustodial parent would be entitled to the exemption would be where the custodial parent relinquishes the right to claim the dependency exemption in a written declaration which the noncustodial parent would be required to attach to his return. The bill also would permit each spouse to deduct amounts he pays for medical expenses of the child. This is done by providing that for purposes of the medical expense deduction the child would be treated as the dependent of both parents. The bill also would make minor amendments to those sections dealing with married individuals living apart, head of household status, the earned income credit, and the child care credit. These changes would make these sections simpler and more consistent with one another, as well as conform them to the new dependency rule.

Discussion

Treasury strongly supports this section of the bill. In many cases, both parties to a divorce will claim a dependency exemption attributable to the same child. The IRS has little choice but to deny the exemption to both taxpayers, even though it knows that one spouse or the other is entitled to the exemption. Although the tax liability involved in these disputes generally does not exceed a few hundred dollars, the parties often are willing (because of the emotional nature of the issue) to litigate the matter at a cost far in excess of the value of the exemption. This wastes judicial and other Government resources and contributes significantly to the case backlog in the United States Tax Court.

The bill proposes a rule which is both simple and fair. While the new rule will not eliminate all controversies in this area, most disputes will be easily resolved by reference to the divorce or separation agreement. Moreover, allowing both parents to treat the child as a dependent for purposes of claiming the medical deduction will take much of the pressure off the allocation of the dependency exemption.

Our only concern relates to joint custody arrangements, which are becoming increasingly common. A strict counting of days may produce unexpected and inequitable results where the parties have been given custody for nearly equal periods but the allocation of the dependency exemption has not been considered. Because most taxayers use tax tables rather than tax rate schedules, splitting the dollar amount of dependency exemption is not a practical solution. Instead, an approach that might be considered would be to allow the dependency exemption to the two divorced spouses in alternate years in any case of joint custody, unless the parties enter into an agreement allocating the exemption to one spouse or the other (similar to the agreement used to allocate the exemption to the noncustodial spouse).

Section 205: Innocent Spouse Relieved of Liability in Certain Cases

Discussion of provisions

Under present law, there are very limited circumstances under which a spouse may be relieved from liability for certain amounts of tax, interest, penalties, and other amounts with respect to a joint return. This is known as the "innocent spouse" rule. The bill would expand the innocent spouse rule in several respects: (1) the rule would cover deductions and credits for which there is no basis in law or fact as well as omissions from gross income; (2) relief would be expanded to cases involving and understatement of tax in excess of the lesser of 10 percent of the tax due or $500; and (3) the spouse claiming relief would no longer be required to show that he derived no significant benefit from the item resulting in the underpayment of tax. The bill also would provide comparable relief in the case of community property income. The amendments made by this section would apply to all open taxable years.

Discussion

While we agree that some additional relief should be available to innocent spouses, we oppose the specific provisions of section 205 of the bill. We recommend that a more limited relief provision be enacted.

When a joint return is filed, both spouses must sign the return, thereby swearing to the truth of the statements contained therein under penalty of perjury. Both spouses are jointly and severally liable with respect to any tax due. The innocent spouse rule provides a very limited exception to the joint and several liability, designed to cover the situation where an individual receives a substantial amount of income which he conceals from both his spouse and the Government. Relief from liability is available only where the innocent spouse can show that (i) he did not know and had no reason to know of the income, (ii) that he received no significant benefit from the concealed income, and (iii) that it would be inequitable to hold him liable for the underpayment of tax resulting from the failure to report such income.

We are troubled by the bill's significant expansion of this relief provision. We recognize that on a complex tax return it may be easy for one spouse to conceal a fraudulent deduction or credit item from the other spouse. Nevertheless, these items are fundamentally different from an omission of gross income in that they appear on the face of the joint return. In addition, the benefit of the reduced tax liability that results from an unjustified deduction or credit arguably inures to the benefit of both spouses. Perhaps in recognition of this distinction the bill also removes the "significant benefit" test.

Without the significant benefit test a major safeguard is removed from the system. We recognize the argument that the significant benefit test is unnecessary in light of the general provision of the bill that relief is available only if, taking into account all facts and circumstances, it is inequitable to hold the spouse liable for the deficiency in tax. This argument might eventually prove to be true, but for the foreseeable future we would expect to see the claim for innocent spouse relief interposed in virtually every case where the IRS attempted to collect from one spouse who signed a joint return an underpayment of tax attributable to the other spouse. The increased availability of the claim for innocent spouse relief would lead to additional litigation and administrative costs. The expansion of the rule to cover any underpayment of tax in excess of $500 or 10 percent of the proper amount of tax substantially exacerbates this problem.

In spite of our opposition to this provision of the bill for the reasons given above, we are sympathetic to those taxpayers who are being held responsible for tax liability resulting from the misdeeds of a spouse or, more often, a former spouse. The case for relief is particularly strong with respect to penalties. While certain penalties may be waived upon a showing of reasonable cause and good faith, and while the fraud penalty cannot be applied to a spouse signing a joint return except to the extent of an underpayment of tax resulting from the fraud of that spouse, there is no relief provision of general applicability. In lieu of this section of the bill, we would suggest a more limited provision allowing an "innocent spouse" to be relieved from liability for penalties upon a proper showing. Treasury would be happy to work with the Committee in formulating such a substitute provision.

Section 206: Deduction Allowed Against Estate Tax for Transfers Satisfying Section 2516

Description of provisions

In general, under current law a transfer from an individual to a former spouse in satisfaction of marital or property rights of the recipient is treated as a taxable gift. Among the various exceptions to this general rule is the safe harbor test embodied in section 2516 of the Code. Under this test, a transfer between former spouses is not subject to gift tax if the transfer is pursuant to a written agreement entered into not more than 2 years prior to divorce and is in settlement of marital or property rights or provides a reasonable allowance for the support of minor children.

This section of the bill would make the estate and gift tax laws consistent by allowing an estate tax deduction for claims arising under a written agreement in settlement of marital or property rights where transfers under the agreement would have qualified under section 2516 as nontaxable for gift tax purposes.

Discussion

Treasury supports this section of the bill. There is no reason to have different rules on this point in the estate and gift taxes. An anomalous result may occur if an individual plans to rely on section 2516 but dies before completing the transfer of property to his former spouse. In such a situation, the property is included in his estate but no deduction is allowed for the claim of the former spouse against the estate. Until the decision this year in *Natchez* v. *United States,* 705 F.2d 671 (2d Cir. 1983), the courts had consistently refused to extend section 2516 to the estate tax area by analogy, in spite of the general rule that the estate and gift tax laws are to be construed in pari materia. The bill would codify the decision in *Natchez* and would remove an unwarranted inconsistency between the estate and gift tax laws.

TITLE III—REVISION OF AT-RISK RULES FOR THE INVESTMENT TAX CREDIT

Section 301: Revision of At-Risk Rules

Present law

Under present law, allowance of the investment credit for individuals and certain closely held corporations generally is subject to an "at-risk" limitation. The investment credit is not allowed for amounts invested in qualifying property to the extent the invested amounts are not at risk, or otherwise are protected from loss. Examples of amounts not considered "at risk" include nonrecourse loans, amounts borrowed from persons who have an interest (other than as a creditor) in the activity in which the property is used, and borrowings from persons such as promoters or persons related to the taxpayer. An exception to the at-risk limitation provides that certain nonrecourse borrowings with respect to property will be considered at risk for purposes of the investment tax credit if the taxpayer at all times has at least a 20 percent at-risk investment in the property and the amount borrowed is owed to certain unrelated "qualified" lenders, who generally are third persons regularly engaged in the business of lending money.

Description of provisions

Section 301 would make a number of technical changes to the present investment credit at-risk limitation, but retain the general principles of the present rules. The principal substantive change involves application of the investment credit at-risk limitation to shareholders of S corporations. The bill would clarify that the determination of the extent to which a shareholder in an S Corporation (as well as a partner in a partnership) is at risk is to be made at the shareholder or partner level. An exception is provided for the proceeds of certain third party (non-seller) recourse loans to an S corporation. These loans are considered to create amounts at risk with respect to the shareholders if (1) the property financed by the loans is used in connection with the active conduct of a trade or business, and (2) the corporation has at least 3 full-time employees whose work directly relates to the trade or business.

Under this rule, eligible property purchased by an S corporation with recourse financing will result in the full investment credit being available to the shareholders even though the shareholders are not personally at risk with respect to the stock of the corporation, the property acquired or the borrowings incurred by the corporation. The bill would exclude from this special rule loan proceeds used to acquire certain literary, artistic or musical properties acquired with third-party loans.

The bill also would authorize the issuance of regulations determining the extent to which amounts are to be treated as nonrecourse loans when they arise out of borrowings from certain related persons or from persons having an interest (other than as a creditor) in the activity in which the financed property is used.

Discussion

We believe the problems addressed by section 301 of the bill deserve attention, but we oppose the approach taken to solve these problems. Section 301 represents a narrow, piecemeal solution to a few technical problems in the present statute and does not go far enough towards making the statute workable. For instance, the bill would exempt shareholders of S corporations from having to be personally at risk in those cases where the S corporation is at risk in respect of a loan and the loan is with respect to property used in an active business. The bill would not exempt similarly situated businesses conducted as limited partnerships when the partners are not personally at risk. We wish to point out that if the investment credit at-risk rules are not to be applied with respect to recourse financing for an active business conducted by an S corporation, they also should not apply to similarly situated partnerships.

Furthermore, the investment credit at-risk limitation is in large part designed to prevent abuses arising from overvaluation of property through use of non-recourse financing for passive "tax shelter" investments. The possibility of abuse is greatest when nonrecourse financing is provided by persons (such as sellers of the property) who have incentives to inflate the value of the property in order to inflate the investment tax credit. There is little potential for this abuse in the case of financing provided by an unrelated third-party lender who can look only to the value of the financed property (or other assets securing the loan) for repayment. The potential for abuse is further diminished where the third-party loan is used to finance property used to conduct an active business. Such businesses are unlikely to present the same opportunities for abuse as passive tax shelters.

For these reasons, we would prefer to see a more complete revision of the investment credit at-risk provisions which would be directed at preventing these overvaluation abuses. We would be happy to work with the Committee in developing this legislation.

The at-risk limitation on the deductibility of losses under Code section 465 presents a similar problem with respect to active businesses. H.R. 883, a bill introduced by Representative Pickle, would allow a closely-held Subchapter C corporation that is engaged in an active business and which meets certain other requirements to use nonrecourse financing without becoming subject to the at-risk limitation on losses. We support the general approach taken in H.R. 883 and would support expanding H.R. 3475 to cover those situations. To the extent that the present at-risk rules frustrate legitimate business transactions or impose unnecessary limitations on taxpayers, relief should be provided.

Finally, there are a number of other technical problems in the present at-risk limitations on both the investment tax credit and the deductibility of losses. Implementation of the at-risk rules has been seriously impeded and taxpayers have had a difficult time complying with the rules because of these problems. We believe that a comprehensive reworking of both the investment tax credit and loss limitation at-risk rules would be desirable at this time, and we would be happy to work with this Committee to that end.

TITLE IV—ESTATE TAX PROVISIONS

Section 401: Permanent Rules for Reforming Governing Instruments Creating Charitable Remainder Trusts and Other Charitable Interests

Present law

The Tax Reform Act of 1969 imposed a number of requirements in order for a charitable deduction to be allowed for the transfer of a split interest in property to charity. In general, the purpose of these rules is to ensure that where a charitable deduction is taken for the transfer of a split interest to charity, the charity will actually receive an interest with a present value equal to the amount of the deduction taken. Because of the difficulty that taxpayers have experienced in conforming with the technical requirements of these rules, Congress on four previous occasions has enacted or extended temporary legislation allowing for the reformation of the governing instruments of charitable trusts not meeting the requirements of the 1969 Act. The last of these temporary provisions expired at the end of 1981.

Description of provisions

Section 401 of the bill would provide a permanent rule allowing for the reformation of defective charitable trust instruments to conform with the 1969 Act requirements. An instrument signed after 1978 could be reformed under this provision, however, only if the charitable interest would have been deductible under the rules in effect prior to 1969 and only if all noncharitable interests in the trust are expressed either in specific dollar amounts or as a fixed percentage of the fair market value of the property. This limitation would deny the right of reformation to any instrument providing for all trust income to be paid to a noncharitable beneficiary or having a power of invasion for one or more noncharitable beneficiaries.

The bill also contains restrictions designed to prevent the reformation process from becoming an opportunity to alter significantly the dispositive plan of the donor. In particular, the bill would require that the actuarial values and durations of the charitable and noncharitable interests in the trust remain the same before and after the reformation. An exception is provided for charitable remainder trusts established for a duration of longer than 20 years (the maximum length of time allowed by statute), which may be reformed to last for 20 years.

If a trust that is otherwise reformable becomes wholly charitable by reason of the death of a noncharitable beneficiary, a deduction will be allowed under the bill for the value of the reformable interests as if it had been reformed.

The introductory statement to the bill indicates that the statute of limitations would remain open until December 31, 1985 to permit reformation, even in situations where the statute of limitations has run. The actual bill, however, contains no such provision. Treasury understands that this omission was an oversight which will be corrected at the earliest opportunity.

Discussion

Treasury supports the enactment of a permanent rule that would allow the reformation of defective split interest trust instruments in order to prevent the loss of a charitable deduction. Loss of the deduction is a harsh santion for a minor defect in a trust instrument. Moreover, loss of the deduction often results in the payment of additional tax with funds that otherwise would pass to charity, thereby harming the very party that the 1969 Act rules were designed to protect.

On the other hand, we do not believe that the reformation rule should be drafted so broadly and so liberally as to leave drafters of split interest trusts with no incentive to comply with the rules of the 1969 Act. In general, we believe that section 401 of the bill strikes a reasonable balance between these competing considerations. In particular, it is not unreasonable to require that instruments executed after 1978 (almost 10 years after the 1969 Act requirements were enacted) must comply with at least the basic requirements imposed by the 1969 Act in order to be reformable.

We are concerned, however, that difficulties may arise from the rule that the actuarial values of the charitable and noncharitable interests before and after reformation must be substantially the same. For example, the effect of a contingency which is the sole reason for the trust failing to qualify for the charitable deduction may be difficult or impossible to value. The rule forbidding a change in the duration of the various interests also may be unduly restrictive. We doubt that any potential for abuse is sufficient to require the inclusion of these safeguards.

We would like to point out a number of related issues which we think should be dealt with in this section of the bill. First, split interest trusts are not the only form of charitable giving in which the charitable deduction is subject to limitation based on highly technical requirements. Other examples include partial interests in farms and personal residences and gifts to pooled income funds. While technical defects in these types of dispositions are relatively rare, we see no policy reason why reformation of these types of interests should not be allowed as well.

The second general issue relates to the effect of a qualified reformation on the trust in question. Our view is that the trust should be governed by the reformed instrument as of the date of its creation (not the date of reformation) for all purposes. Thus, if the trust is a tax-exempt entity under the reformed instrument, it should be treated as tax-exempt during the period prior to reformation as well. Also, any distributions made or other actions taken during the period prior to reformation that are inconsistent with the reformed instrument should be corrected in conjunction with the reformation. While the details of the adjustment process could be left to Treasury regulations, the requirement of appropriate adjustments should be imposed by statute. Finally, where a charitable deduction is allowed because of a qualified reformation, no interest should be charged on the tax deficiency that existed prior to the reformation. This would require a statute to overrule the result in Revenue Ruling 80-291, 1980-2 C.B. 373, and in Regulation § 24.1(f). We would recommend that this new interest rule be applied prospectively only.

Section 402: Alternate Valuation Election Available Only Where It Results in Reduction of Gross Estate and Estate Tax

Present law

Under present law, the executor of an estate may elect to have property in that estate valued as of the date which is six months after the decedent's death (the "alternate valuation date") rather than on the date of death. The alternate valuation date election was intended to lessen the impact of the estate tax when the decedent's property declines in value shortly after the date of death.

Description of provisions

In order to limit the alternate valuation date election to its original purpose, section 402 of the bill would make the election available only when it would result in both a reduced value for the gross estate and a smaller estate tax liability. Without these restrictions, the election can be used to obtain a higher income tax basis for an estate's assets in cases where the assets in the estate have increased in value within 6 months after the decedent's death. Since the unlimited marital deduction now allows a decedent to pass all of his property to the surviving spouse with no estate tax liability, current law permits the spouse to obtain the higher income tax basis without any estate tax cost.

Discussion

Treasury strongly supports this proposed change. The alternate valuation date election was never intended to allow estate beneficiaries to obtain a higher income tax basis as a result of appreciation in value subsequent to death. We see no reason why the Code should allow the election to be used for this purpose.

The two restrictions proposed in section 402 of the bill will ensure that the alternate valuation date election is used only in the situations Congress originally envisioned. The requirement of a reduction in the estate tax liability will deny the alternate valuation date election to those estates which are paying no estate tax because of the unified credit and the unlimited marital deduction. This test alone, however, is not sufficient. If this were the only restriction, an estate with primarily appreciated assets but with some assets which have declined in value could use the alternate valuation date election to obtain a higher basis for the appreciated assets while achieving a small amount of estate tax savings by allocating the depreciated assets to the portion of the estate passing to beneficiaries other than the surviving spouse. Hence, we support the additional requirement that the election should be available only when the total gross estate has declined in value.

Another approach to this problem which merits consideration would be to provide that when an alternate valuation date election is made, the basis for income tax purposes of each asset in the decedent's estate in the beneficiary's hands shall be the lower of its value on the date of death or the alternate valuation date. This rule would be as effective as section 402 of the bill in preventing the use of the alternate valuation date election to obtain a higher basis for appreciated assets and might permit the election to be made in a few cases where it would be denied under the bill. For example, if an estate had generally increased in value but the value of those assets passing to taxable beneficiaries had declined, and if the basis of the appreciated assets were not a major concern to the recipients of those assets, the alternate valuation date election could be made to achieve some estate tax savings. We point out, however, that estates with assets that overall have declined in value but which include some appreciated assets would be better off under the bill than under this alternative approach since the recipients of the appreciated assets would have a higher basis for those assets.

Section 403: Alternate Valuation Election Available on Late Return

Description of provisions

Under current law, an executor may elect the alternate valuation date only on a timely filed estate tax return (taking into account any extensions granted). The bill would allow executors of estates of decedents dying after enactment of the bill to use the alternate valuation date even when the return is filed late. The bill would not, however, permit an executor to file an amended estate tax return electing alternate valuation.

Discussion

Treasury generally supports this provision of the bill. We believe, however, that the bill should impose some time limit (such as one year after the time prescribed for filing the return, taking extensions into account) on making the election. This time limit would avoid the administrative problems that would be involved with changes in the income tax basis of property if the return is filed long after the due date.

TITLE V—FOREIGN TAX PROVISIONS

Title V of the bill would amend certain of the foreign provisions of the Code. We strongly support each of these proposals.

Section 501: Definition of Resident Alien and Nonresident Alien

Present law

United States citizens and residents are subject to U.S. tax at the normal graduated rates on their worldwide income. In contrast, nonresident aliens are subject to U.S. tax only on certain types of passive income from U.S. sources at a rate of tax equivalent to 30 percent of the gross amount of such income and on income effectively connected with the conduct of a trade or business within the United States, which income is generally taxed at the normal graduated rates. Bilateral income tax conventions to which the United States is a party may effect these general rules in a manner favorable to the treaty-protected foreign recipient.

The status of an alien as either resident or nonresident is fundamental to determining the applicable regimen of taxation and therefore has significant tax consequences. Although, the Code contains no definition of the terms resident alien or nonresident alien, Treasury regulations define the terms by reference to an alien's intention with respect to the length and nature of his stay within the United States. The regulations contain a rebuttable presumption that an alien is a nonresident by reason of his alienage; this presumption may be rebutted by showing, for example, that an alien has committed acts or made statements showing a definite intention to acquire residence in the United States.

Since an alien's residence depends upon an analysis of his subjective intent as manifested by his actions, the IRS and courts have looked to a broad variety of factors to assist them in making this determination.

Given that the current standard with respect to determining the residence of an alien is somewhat subjective, aliens sometimes arrange their affairs to file as resident or nonresident, depending on which is most advantageous in their circumstances. Moreover, the IRS is not easily able to audit aliens who claim nonresident status since if an alien takes the position that he is a nonresident, a Federal income tax return often is not required to be filed by such individual. It is, therefore, highly desirable to provide more precise, easily applied, objective standards of residency.

Description of provisions

Pursuant to section 501, an individual would be treated as a resident with respect to any calendar year if the individual:

(1) Is granted the right to reside permanently in the United States as an immigrant at any time during the calendar year;

(2) Has an application pending for an immigrant visa at any time during the calendar year and is present in the United States at least 60 days during the calendar year; or

(3) Is present in the United States for a substantial period of time. (An individual meets the "substantial presence test" if the sum of the days the alien is in the United States during the current year; plus two-thirds of the days present during the preceding year; plus one-third of the days present during the second preceding year, equals or exceeds 183 days.)

An individual would not be deemed a resident by virtue of the substantial presence test even where the 183 day test is satisfied if the individual was present in the United States for fewer than 183 days during the current year and it is established by the IRS or the alien, as the case may be, that the alien has a tax home in a foreign country and closer connections to that foreign country than to the United States.

In addition, certain categories of individuals would be exempt from the substantial presence test. Foreign government-related individuals (e.g., diplomats), teachers or trainees, and students would be exempt for a given year provided that the facts and circumstances do not indicate that the individual intends to permanently reside in the United States. Teachers and trainees generally could avail themselves of this exemption for only two years of any six-year period. After five years, a student who wants to continue to qualify for the exemption would have to establish to the satisfaction of the Secretary that he does not intend to reside permanently in the United States and is substantially complying with the requirements of his visa.

The bill would define presence in the United States during a day to be presence at any time during such day, but would exclude days during which a regular commuter travels to employment (or self-employment) from Canada or Mexico.

The bill would authorize the Secretary to prescribe regulations requiring individuals who claim exemption from the substantial presence test to file annual statements stating the basis for claiming their exemption. Treasury intends to utilize this provision in an attempt to eliminate one of the major compliance problems facing the IRS in this area. As discussed above, many aliens who claim to be nonresident have structured their affairs so as to avoid filing any Federal income tax return. The IRS, therefore, has little information with respect to these individuals. This provision would permit the IRS for the first time to obtain information which will enable it to make determinations with respect to many individuals claiming nonresident status.

Discussion

The concept of residence has received a great deal of attention in recent years because of the lack of clear, objective guidance. Section 501 of the bill goes a long way toward alleviating the uncertainty that now exists. We believe the proposal is a reasonable compromise between the desire for definitive objective rules and the need for flexibility required by varying facts and circumstances.

The remainder of the provisions of Title V for the most part would make technical changes to various of the foreign provisions of the Code. Certain of these are clarifying in nature, while others correct technical problems which have been brought to the attention of Treasury and the Committee's staff. We strongly support these changes.

Section 502: Treatment of Community Income

Description of provision

Section 502 of the bill deals with the taxation of community income and would amend Code section 879. Under present law, if an individual is a U.S. citizen or resident and his spouse is a nonresident alien, the couple cannot file joint returns and generally cannot take advantage of the United States' progressive income tax structure by using community property laws of foreign countries to split their earned income. However, if both spouses are nonresident aliens and they reside in a country that has community property laws, they may be able to split the U.S. earned income of one spouse, thereby reducing their combined U.S. tax liability.

The bill would provide that if either spouse is a nonresident alien, the couple cannot use foreign community property laws to split their United States earned income. This bill, therefore, would treat all married couples with at least one nonresident alien member similarly, regardless of whether they are from a common law or a community property country, which we believe is the proper result.

Section 503: Amendments Related to Foreign Personal Holding Companies

Present law

A foreign personal holding company is defined generally as a foreign corporation which meets an objective gross income test and is owned, directly or indirectly, more than 50 percent in value by five or fewer individuals who are U.S. citizens or residents. For purposes of determining whether a corporation satisfies this stock ownership test, the Code contains stock attribution rules. For example, an individual is considered to own stock of a foreign corporation owned by family members. Thus, a U.S. person who owns a small amount of stock in a foreign corporation technically can be subject to current taxation under the foreign personal holding company provisions with respect to the stock actually owned by such person if the remainder of the stock of the foreign corporation is owned by an unrelated nonresident alien individual whose brother, for example, is a U.S. resident. Under the controlled foreign corporation provisions of the Code, such stock attribution could not occur.

Description of provisions

The bill would preclude stock attribution from a nonresident alien individual to a U.S. citizen or resident (except in the case of spouses) under the foreign personal holding company family attribution rules. This amendment would clarify existing law and prevent current taxation of the income of a foreign personal holding company where such taxation would be inequitable.

The bill also would correct an ambiguity in the foreign personal holding company provisions. Some taxpayers have asserted that, under current law, a U.S. person may avoid current taxation of foreign personal holding company income by holding the stock of the foreign personal holding company through a foreign partnership, estate or trust, or through a foreign corporation which is not itself a foreign personal holding company. The argument in support of this position is that, while stock ownership of a foreign corporation flows through such entities for purposes of determining whether a foreign corporation satisfies the U.S. ownership requirement of a foreign personal holding company, the income of a foreign personal holding company is taxed only to U.S. citizens or residents, domestic corporations and domestic partnerships, estates and trusts actually owning stock in the foreign personal holding company.

The bill would provide that stock of a foreign personal holding company held by a foreign partnership, estate or trust or by a foreign corporation that is not a foreign personal holding company also would be treated as owned by such entity's partners, beneficiaries or shareholders for purposes of taxing the income of the foreign personal holding company. This provision would make it clear that current taxation under the foreign personal holding company provisions cannot be avoided by the relatively simply expedient of interposing a foreign entity to hold the stock of the foreign personal holding company. We note that collateral tax adjustments (such as a need to create a previously taxed income account in the case of shares held through a foreign corporation) may be required, and the bill would grant the necessary authority to the Secretary to provide through regulations for any such adjustments. We believe that this authority would enable us to ensure that the provision would operate in its intended manner.

Section 504: Amendments Related to Section 1248

Present law

Section 1248 provides generally that if a U.S. person sells or exchanges stock in a controlled foreign corporation, an amount not in excess of the gain recognized on the disposition is included in the seller's gross income as a dividend, limited to the extent of the corporation's earnings and profits accumulated while the U.S. person held the stock and while the corporation was a controlled foreign corporation.

One issue arguably not addressed by section 1248 in its current form is the effect of a section 1248 dividend on the corporation's earnings and profits for purposes of determining the taxation of an actual distribution in a subsequent year by the corporation to the new holder of the stock. If the corporation's earnings and profits are not in effect reduced by the amount of the section 1248 dividend taxable to the seller, the buyer may be required to include a distribution from such earnings in income as a dividend in the event of an actual distribution. This creates the possibility that both the buyer and the seller may be subject to dividend taxation on the same earnings and the possibility that both the buyer and the seller may be able to claim the same deemed paid foreign tax credits associated with such earnings. This possibility may cause unintended detrimental or beneficial tax consequences.

Description of provisions

The bill would conform the effect of section 1248 dividends on the earnings of a controlled foreign corporation to analogous foreign provisions of the Code. A previously taxed income account for amounts previously taxed as section 1248 dividends would be created which would preclude multiple taxation of the same earnings or multiple use of the same deemed paid foreign tax credits. While this change may introduce some additional complexity, we believe that this provision would be an extremely helpful clarification of existing law.

The second amendment to section 1248 also would be of a clarifying nature. The amendment can best be illustrated by the following situation. A U.S. person owns 100% of the stock of two controlled foreign corporations (F1 and F2). After 10 years, it transfers the stock of F2 to F1 in a non-recognition transaction which has received section 367 clearance. Two years later, the U.S. person sells the stock of F1 at a gain. It has been suggested that under an extremely literal reading of section 1248, the U.S. person must only recharacterize its gain as a dividend to the extent of the earnings of F1 and only with respect to F2's earnings that were accumulated while F1 owned F2, thereby not including the earnings of F2 accumulated while such entity was owned by the U.S. person directly.

We do not believe this interpretation of section 1248 is proper. The bill would confirm that, in the above situation, earnings accumulated while F2 was owned directly by the U.S. person also will be counted for purposes of section 1248. We view this amendment as merely confirming present law.

Section 505: Coordination of Subpart F With Foreign Personal Holding Company Provisions

Present law

A foreign corporation can be classifed as both a foreign personal holding company and a controlled foreign corporation. In such a case, section 951(d) of the Code provides a rule for coordinating shareholder taxation under these two sets of anti-avoidance rules.

Some courts have interpreted this coordination rule to mean that if any amount of the foreign corporation's income is taxed to a U.S. person under the foreign personal holding company provisions, no amount can be taxed to that U.S. person under the controlled foreign corporation provisions. Taken to its extreme, this rule can result in the avoidance of taxation in the following situation: Assume a controlled foreign corporation has tax-deferred earnings and profits and makes an investment in U.S. property as defined in section 956 (which is potentially taxable to the corporation's U.S. shareholders under section 951) and further assume the U.S. shareholder causes the foreign corporation to be treated as a foreign personal holding company by generating a de minimis amount of foreign personal holding company income. The U.S. shareholder would be currently taxed only on the de minimis amount of foreign personal holding company income and not under the Subpart F income provisions on its investment in U.S. property or other Subpart F income, if any. While there is contrary authority in other courts, this is obviously a matter of concern. This situation illustrates a case where the intent of Congress was to subject the corporation to two anti-abuse rules and the taxpayer, in effect, avoids both.

Description of provision

The bill would amend section 951(d) of the Code to provide that where an amount of income would be includible in the gross income of a U.S. shareholder both as Subpart F income under the controlled foreign corporation provisions and as foreign personal holding company income under the foreign personal holding company provisions, the income is includible only under the controlled foreign corporation provisions. Income includible under only one of the provisions would be includible under that provision. Thus, the bill would properly reflect the interaction of the two anti-avoidance rules—a U.S. shareholder would be subject to tax on the full amount of the foreign corporation's tainted income, not more and not less.

I wish to point out that the need for this amendment, as well as those in section 503 of the bill, stems in part from the existence of two somewhat overlapping sets of anti-avoidance provisions. In the future it may be useful to examine the possibility of merging these two provisions.

Section 506: Stapled Stock; Stapled Entities

Present law

A staple stock transaction is a technique whereby there is an attempt to prevent, for example, the controlled foreign corporation and boycott provisions of the Code from applying to a foreign subsidiary of a U.S. parent corporation. The U.S. parent corporation first distributes the stock of the foreign subsidiary to its shareholders. The stock of the U.S. corporation and the foreign corporation are then "stapled" or "paired"—i.e., the stock of the two corporations thereafter can only be traded as a unit. If the U.S. parent corporation's shareholders are sufficiently diverse, it can be argued that the controlled foreign corporation and boycott provisions are avoided because the requisite control tests are not satisfied.

These transactions also have been utilized by domestic corporations in efforts to avoid the rules relating to the prevention of multiple rate bracket amounts with respect to controlled groups, and in efforts to avoid the prerequisites for treatment as a real estate investment trust or regulated investment company where the company wishes to engage in non-qualifying activities. Although the precise mechanism for the structure may be different than in the foreign area, the intended result is the same—keeping effective control of the subsidiary in the same hands while avoiding various restrictions or limitations that would apply if the subsidiary were owned directly by the parent corporation.

Description of provision

Section 506 of the bill would curtail the use of stapled stock transactions for tax avoidance purposes. The bill would provide generally that where a foreign and a domestic corporation are stapled entities, the foreign corporation would be treated as domestic. The bill also would provide rules governing stapled stock of domestic corporations. For example, all stapled entities would be treated as one in determining whether any one is a REIT or RIC. The Secretary could modify these rules by regulation and prescribe such other rules by regulations as would be necessary to prevent tax avoidence. We are pleased that this issue is addressed in the bill and with the flexibility granted to deal with the many issues arising from such transactions.

I also wish to note with approval the provision deferring the effect of the amendment with respect to pre-existing stapled stock arrangements until January 1, 1985. This deferral would give those companies having existing stapled stock arrangements sufficient time to unwind those arrangements, if they so desire.

TITLE VI—MISCELLANEOUS TREASURY ADMINISTRATIVE PROVISIONS

The provisions of Title VI of the bill take several important steps in improving the administration of the Department of the Treasury. We commend the Committee for recognizing that it is important for the Department to be administered efficiently, and strongly support this Title of the bill.

Section 601: Simplification of Certain Reporting Requirements

Discription of provision

The Department of the Treasury is required to report to Congress periodically on activities relating to certain provisions of the Code. Section 601 of the bill would simplify certain of these requirements as they relate to reports filed with respect to (1) the operations of DISCs and possessions corporations, (2) taxes paid by taxpayers with high income and (3) the international boycott provisions.

The proposed changes would permit the Department to avoid unnecessary duplications of effort and to conserve limited statistical and analytical resouces. Moreover, under the revised reporting requirements the Department would be able to provide Congress with a comprehensive analysis of the subjects covered by these reports.

Section 602: Removal of $1 Million Limitation on Working Capital Fund

Description of provision

At present, the Treasury's Working Capital Fund ceiling is $1 million. The fund provides for the financing of centralized, Department-wide printing and telecommunications services. The bill would eliminate the $1 million ceiling which was set in 1970 when the fund was established.

Removing the ceiling has no budgetary impact, and it would enable the Department to acquire and manage the acquisition of printing and telecommunications services more efficiently.

Section 603: Increase in Limitation on Revolving Fund for Redemption of Real Property

Description of provision

Section 603 of the bill would increase the amount authorized for the real property redemption revolving fund from $1 million to $10 million.

Discussion

The real property redemption revolving fund provides important assistance to the IRS in collecting amounts owed by delinquent taxpayers. Section 7810(a) of the Code currently authorizes a revolving fund of not more than $1 million to be used for the redemption of real property. That section provides the IRS with funds to redeem real property on which it has a junior lien when the property has been sold at a foreclosure sale brought by a senior lienholder. Typically, the IRS redeems real property that has been sold at a distress price which is insufficient to satisfy the IRS's claim and immediately resells the property at a profit sufficient to cover all or a portion of the delinquent taxes, interest and penalties owing. Any excess profit is available to other creditors and the taxpayer. In order to minimize the risk in redeeming property in these foreclosure transactions, the IRS often obtains a 25 percent cash deposit from a prospective purchaser prior to making the redemption.

In addition to enhancing the IRS's collection capabilities, the redemption procedure helps delinquent taxpayers to discharge their tax-related debts and provides some degree of assurance that upon foreclosure of their real property interests they will receive credit for a sales price that is not unfairly low.

Over the past several years, increases in the number of taxpayer delinquencies, escalating real property values, and a greater frequency of foreclosures have repeatedly combined to drain temporarily the revolving fund. In addition, on several occasions the IRS has had no choice but to pass up redemptions requiring funds in excess of $1 million where the property could easily have been resold at a profit at least equal to the IRS's claim. To protect against recurrence of these events, the bill provides that the amount in the real property redemption revolving fund be increased from $1 million to $10 million.

In our view, increasing the amount authorized for the real property redemption revolving fund would be an important change that would improve the IRS's ability to collect delinquent taxes, interest, and penalties. Accordingly, Treasury supports the amendments contained in section 603 of the bill.

Section 604: Secretary of the Treasury Authorized to Accept Gifts and Bequests

Description of provisions

The bill would permit the Secretary of the Treasury to accept gifts and bequests of property for the purpose of aiding or facilitating the work of the Treasury Department. Under present law the Secretary can accept such gifits and bequests only to be applied to the public debt or to be used for defense purposes. Authority to receive gifts and bequests of property for other purposes has been enacted for numerous other agencies, including the Department of Commerce and the Department of Transportation.

Discussion

We strongly support this provision. It would permit the Department to accept gifts for the purpose of aiding the work of the Department, including reimbursements for travel expenses related to speaking engagements. The Department would carefully control the exercise of its authority to accept these gifts in strict compliance with applicable laws and regulations concerning ethical and conflict of interest standards.

Section 605: Repeal of Stamp Requirements for Distilled Spirits

Description of provisions

Section 605 of the bill would repeal the Code provisions requiring stamps on containers of distilled spirits to evidence the payment of the excise taxes imposed on those products.

Under present law, containers of distilled spirits, with enumerated exceptions, must bear certain stamps. The Treasury Department is required to furnish these stamps without charge. The bill would repeal Code section 5205, relating to stamps, and section 5604, concerning the various penalty provisions relating solely to stamp violations. Conforming changes would be made in other Code provisions referring to stamps, stamping, or restamping of containers of distilled spirits. These changes would be effective January 1, 1984.

Discussion

We support this provision of the bill. Following the enactment of the Distilled Spirits Tax Revisions Act of 1979, prescribing an all-in-bond system for domestic distilled spirits plants, Treasury's Bureau of Alcohol, Tobacco and Firearms has eliminated day-to-day on-site supervision of distilled spirits plant operations, and is implementing an audit-oriented approach to ensure full collection of taxes due. Under this approach, it is no longer cost-effective for the Federal government to continue to spend almost $2 million each year to print the stamps currently required on containers of distilled spirits. Historically, these stamps served as evidence that the packager, bottler, or importer of the spirits had fully complied with the provisions of Chapter 51, and, when applicable, had paid all taxes due on the spirits. However, because of the recent changes in the laws governing the regulation of distilled spirits and the supervision of domestic distilled spirits plant operations, these stamps have negligible value from a compliance standpoint. Repeal of this requirement would help lessen the economic burden to the Government and to the private businesses that must account for and affix such stamps on containers of distilled spirits.

Treasury's only concern with the repeal of this stamp requirement is that these stamps currently may be serving the ancillary function of indicating when a bottle may have been opened prior to its purchase at the retail level. This concern would be eliminated, however, if, in conjunction with the repeal of this stamp requirement, Congress were to add a requirement that distilled spirits be marketed in tamper-proof containers. The Administration currently is developing proposed legislation that would require a closure device to be installed on every distilled spirits container other than bulk containers. We would be happy to submit our proposal to you for your consideration.

Finally, we point out that there are several additional technical changes which should be added to section 605 of the bill in order to conform the repeal of the stamp requirement to other sections of Chapter 51. We would be happy to work with members of your staff to make these additional changes.

Section 606: Extension of Period for Court Review of Jeopardy Assessment Where Prompt Service Not Made on Secretary

Description of provision

Section 606 of the bill would provide that the government must receive notice that a taxpayer has sought judicial review of the reasonableness of a jeopardy assessment at least 15 days before the court is required to decide the issue.

Discussion

In circumstances where the IRS reasonably believes that collection of a proposed tax deficiency would be jeopardized if prompt action is not taken, it is authorized by sections 6851 and 6861 of the Code to assess and collect immediately the amount in jeopardy. Section 7429 of the Code provides the taxpayer with certain safeguards against the possibility of arbitrary assessments. First, the taxpayer may request expeditious review by the Secretary (through the local IRS district director) of the propriety of the assessment. After such review, the taxpayer also may challenge the assessment by filing suit against the Government in United States District Court. That court is required to decide, within 20 days after the action is filed, whether the determination of jeopardy and the amount of the assessment were reasonable under the circumstances. However, neither section 7429 nor the Federal Rules of Civil Procedure requires that service of process be made on the Government within the 20-day period. Thus, often the Government is not given enough notice to permit it to prepare its case adequately. Section 606 of the bill would amend section 7429 to provide that unless the Government is properly served within 5 days of commencement of the action, the 20-day period for the District Court's decision shall not begin until proper service has been made on the Government.

Treasury fully supports the amendment contained in section 606 of the bill. In our view, this change is essential to protect the government from being put in an inequitable and unprepared litigating position and to uphold the effectiveness of jeopardy assessments in those circumstances where they are necessary. From a technical standpoint we recommend that in order to conform to the correct service of process procedure, the proposed statutory references to "the Secretary" be changed to "the United States".

Proposed Section 607. Removal of $1 Million Limitation on Secretary's Special Authority to Dispose of Obligations

In addition, I wish to take this opportunity to suggest that another administrative area of special significance to the Treasury be addressed by the bill.

Under present law, the Secretary has authority, outside of the context of the Federal Property and Administrative Services Act of 1949, to dispose of obligations acquired by the Secretary for the United States or transferred to the Secretary by an executive agency. The Secretary also may make arrangements to extend the maturity of such obligations. The Secretary is authorized to dispose of or extend the maturity of obligations "in the way, in amounts, at prices, and on conditions the Secretary considers advisable and in the public interest." The provision has been in effect since 1945, and was designed, in part, to allow for the expeditious disposition of obligations without market disruption and loss that might result from lengthy disposal procedures. Since the section was enacted in 1945, it has contained a limitation of $1 million on the maximum par value of obligations of one issuer that could be held for such disposition. If no-par obligations are involved, the $1 million limitation applies to the stated or book value of such obligations.

Because of changes in both the capitalization of entities in which the United States has acquired an interest (most frequently as a result of claims in bankruptcy) and inflation, this $1 million limitation restricts the ability of the Secretary to obtain the best value for the United States in disposition transactions. We strongly recommend that limitation be repealed as part of this larger legislative action to improve the efficient operation of the Department.

TITLE VII—TAX COURT PROVISIONS

Description of provisions

The bill would provide that:

(1) Any certified public accountant or enrolled agent authorized to practice before the IRS could represent taxpayers before the Tax Court in "small cases" in which the amount in dispute is $5,000 or less.

(2) The examination by which persons other than lawyers may qualify to represent taxpayers in Tax Court proceedings would be eliminated. Those who have successfully completed the examination and have been admitted to practice before the Tax Court prior to the date of enactment of the bill would be authorized to continue representing taxpayers before the court in all Tax Court proceedings.

(3) Annuities paid to survivors of Tax Court judges would be placed in parity with the annuities paid to survivors of Federal judges.

(4) Commissioners of the Tax Court would be renamed "special trial judges", and their authority in regard to certain Tax Court proceedings would be made explicit.

(5) The authority of the Tax Court to take action necessary to prevent the disclosure of trade secrets and other confidential information received by the court during proceedings before it would be recognized by statute.

Discussion

The Treasury Department endorses the provisions of the bill relating to the Tax Court. We believe that these changes would help make Tax Court proceedings more efficient and fairer to taxpayers.

In general, we believe that the Tax Court is best able to decide who should be entitled to practice before it. Thus, we recommend that the Committee consider amending the bill to grant this authority to the court. Certainly, the Committee should give serious consideration to the testimony that will be given by the Tax Court on this subject.

Elimination of the admission by examination procedure for nonlawyers will mean that only lawyers and persons previously admitted under the examination procedure will be able to represent taxpayers in "large case" proceedings. Although some objections to this change undoubtedly will be heard, we believe that the costs of maintaining the admission by examination procedure far outweigh its benefits. Few applicants pass the examination administered by the Tax Court; from 1978 through 1982, on average fewer than four persons per year passed. During this period fewer than eight Tax Court petitions per year were filed by nonlawyers admitted by examination, representing less than one-half of one percent of all petitions filed. Moreover, the costs of maintaining the examination are great, as measured both in the time of judges spent in reviewing the examinations and in the cost of hiring lawyers and law professors to draft and assist in grading the examinations. We think these factors outweigh any detrimental effects that may result from the small decrease in nonlawyer representation in "large cases" caused by elimination of the admission by examination procedure.

TITLE VIII—SIMPLIFICATION OF INCOME TAX CREDITS

Present law

Within certain limits, present law provides for various nonrefundable personal and business tax credits against a taxpayer's tax liability. The relative availability of a particular credit may be the product of numerous factors: the priority of the credit in the order of application, the nature of the limit (if any) imposed on the credit allowed for a particular year, whether carrybacks or carryforwards of the unused portion of a credit are available, and the other in which carrybacks, carryforwards, and current-year credits are allowed.

The credits under present law have been enacted on a piecemeal basis. Thus, different rules govern the availability of each credit, with the result that the interaction among the various rules is not only complex, but often illogical. For example, the relative priority of credits largely reflects the chronological order of their enactment. This means, for example, that a taxpayer may be required to utilize investment tax credits before dependent care credits even though (unlike unused investment credits) unused dependent care credits may not be carried forward. In addition, present law imposes a variety of different percentage limitations on the amount of a taxpayer's tax liability for a particular year against which the nonrefundable credits may be used.

Finally, if an unused credit may be carried back or forward, the order in which the current year and the carried credits are to be used is determined under either the first-in-first-out (FIFO) rule or the current-year-first rule. Present law provides that only investment credits are ordered under the FIFO rule. Under this rule, carryforwards to the current year are allowed before current-year credits, which in turn are allowed before carrybacks from subsequent years. Under the current-year-first rule, current-year credits are allowed before carryforwards to the current year, which are allowed before carrybacks to the current year.

Description of provisions

Title VIII of the Act proposes to group the nonrefundable credits presently available into three categories based on their appropriate order of application and to standardize, to the extent possible, the applicable rules so that their interaction would be both less complex and more rational.

Under the bill, the nonrefundable personal credits (the dependent care, elderly and disabled, residential energy, and political contribution credits) would be given first priority. For a particular year, these would be allowed against the taxpayer's tax liability before any other credits for that year. Although the bill would continue to permit the nonrefundable personal credits to offset 100 percent of a taxpayer's tax liability, the bill would redefine "tax liability" to exclude certain minimum, penalty, excise, and other taxes. Under current law, these taxes can be offset by the nonrefundable personal credits, but generally are excluded from the taxpayer's tax liability for purposes of the limits on the other available credits, such as the foreign tax and investment credits.

Second priority under the bill would be given to a category of nonrefundable credits made up of the foreign tax, clinical testing, and nonconventional fuel credits. This second category of credits generally would be allowed against 100 percent of a taxpayer's tax liability under the same rules that presently apply, and the bill would continue the present law rules permitting unused foreign tax credits to be carried back two years and forward five years.

The third category of nonrefundable credits under the bill would contain the business credits: the investment tax credit, the targeted jobs credit, the alcohol fuel credit, the research activities credit, and the ESOP credit. These credits, which are governed by separate limits and rules under present law, would be combined into a single business credit subject to a single, aggregate limitation on the taxes against which they can be applied and to a single set of carryback and carryforward rules.

By giving these credits last priority, the bill generally reduces the priorities of these business credits in the order of application, as compared with present law. In addition, the bill repeals the different limitations applicable to the separate business credits under present law and imposes on the combined business credit the same limitation that presently applies to the investment tax credit (other than the energy credit): 100 percent of the taxpayer's first $25,000 of tax liability and 85 percent of the excess of the tax liability over $25,000.

The bill also would made the investment tax credit carryback and carryforward rules applicable to the combined business credit. Accordingly, unused business credits may be carried back three years and carried forward fifteen years. More significantly, in this regard, the bill would adopt the FIFO rule for ordering the business credit carrybacks, carryforwards, and current-year credits. The different rules governing the various credits and the treatment of these credits under the bill are summarized in the table set out below.

Name of credit	Section number		Order of application		Tax liability limitation (percent)		Carryback/forward years		Order of use [3]	
	Current	Bill	Current	Bill	Current	Bill	Current	Bill	Current	Bill
Elderly	37	22	1	[1] 1–3	100	100				
Foreign tax	33	28	2	5	100	100	2/5	2/5	C	C
Investment	38/46	38/46	3	[1] 8–12	[2] 85	[2] 85	3/15	3/15	FIFO	FIFO
Invest—Energy	38/46	38/46	4	8–12	100	[2] 85	3/15	3/15	FIFO	FIFO
Political contributions	41	24	5	1–3	100	100				
Dependent care	44A	21	6	1–3	100	100				
Targeted jobs	44B/51	38/51	7	8–12	90	[2] 85	3/15	3/15	C	FIFO
Residential energy	44C	23	8	4	100	100	0/6	0/6	C	C
Nonconventional fuels	44D	30	9	7	100	100				
Alcohol fuels	44E	38/40	10	13	100	[2] 85	0/15	3/15	C	FIFO
Research	44F	38/41	11	8–12	100	[2] 85	3/15	3/15	C	FIFO
ESOP	44G	38/42	12	8–12	[2] 90	[2] 85	3/15	3/15	C	FIFO
Clinical testing	44H	29	13	6	100	100				

[1] "1–3" and "8–12" mean that the credit is combined with the other credits that are classified "1–3" or "8–12," respectively.

[2] 100 percent for the first $25,000 of tax liability.

[3] C means current-year-first. FIFO means first-in-first-out.

Discussion

The Treasury Department generally supports the provisions of Title VIII of the bill, but we strongly oppose the provision of the bill that reduces the amount of tax liability that may be offset by the research activities credit.

The bill would rationalize the rules governing, and the relationships among, the existing nonrefundable tax credits in ways that would eliminate much of the complexity and inconsistency in the existing provisions. The increase in the priority of the nonrefundable personal credits—the dependent care, elderly and disabled, residential energy, and political contributions credits—would increase the likelihood that these credits would be utilized. The provisions of current law that require a taxpayer to use other credits, for which carrybacks and carryforwards are available, before the nonrefundable personal credits has resulted in these later credits being wasted.

With the exception of the alcohol fuel credit, the reduction in the priorities accorded the business credits would not have an adverse impact on taxpayers. As stated above, the principal effect of this reordering vis-a-vis the nonrefundable personal credits is to reduce the risk of wasting these latter credits. In addition, use of the FIFO rule for ordering the current year and carried business credits would maximize the likelihood that the business credits will be used before the completion of the carryforward period.

The reduction in the order of application of the alcohol fuel credit, however, is more significant. The bill appears to provide that the various—formerly separate—business credits are to be combined into a single business credit allowed under uniform rules. The alcohol fuel credit, however, actually would be allowed only after the other business credits. Presumably, the reason for this is that no unused alcohol fuel credits can be carried forward to years after 1994, and as a result a taxpayer and the IRS must be able to separate the alcohol fuel credits from the general business credit carryforwards. However, ordering the alcohol fuel credit last would increase the likelihood that these credits will not be utilized. The availability of carrybacks for unused alcohol fuel credits may reduce to some extent this effect.

I wish to point out that it also may be necessary to order the other business credits. For example, a taxpayer can deduct any unused investment tax credits and ESOP credits, respectively, at the end of the applicable carryforward period. Thus, it will be necessary to be able to calculate that portion of a taxpayer's investment tax credit and ESOP credit that remains unused at the end of the period. This cannot be done if these credits are simply lumped with the other business credits, into a single business credit. Similar problems arise under the investment credit recapture provisions.

Limiting the tax liability against which the targeted jobs, alcohol fuel, research activities, and ESOP credits may be used to the limitations currently applicable with respect to the investment tax credit (other than the energy credit) may reduce the availability of these credits. The extent to which this limitation actually translates into a reduction in the availability of these credits, however, will be affected by a number of factors, including the interplay of these credits and the minimum tax provisions of the Code.

It is not clear at this time whether or not the extension of the 85 percent of tax liability limitation under the bill would represent a significant reduction in the availability of the business credits. We will continue to analyze the revenue impact of this provision of the bill, but I wish to reemphasize at this point that we will oppose any provision which reduces the effectiveness of the research activities credit.

TITLE IX—REPEAL OF CERTAIN OBSOLETE PROVISIONS

Section 901. Termination of Rules Relating to Qualified Bond Purchase Plans and Retirement Bonds With Respect to Bonds Issued After December 31, 1983

Description of provision

The bill would repeal the rules that govern retirement bonds, issued under the Second Liberty Bond Act, that either are used to fund employers' qualified bond purchase plans or are purchased by individuals with deductible contributions not in excess of $2,000 annually. Retirement bonds under a qualified bond purchase plan are not included in an individual's income until they are redeemed, which is not permitted until the individual dies, becomes disabled, or attains age 59½. The same rules apply to retirement bonds purchased by individuals, except that while these bonds may be redeemed before age 59½, the tax on such redemption is increased by 10 percent of the includible amount of the redemption. In either case, however, the proceeds of a redemption may be rolled over to an IRA, without tax, within sixty days of the redemption.

The repeal of these provisions generally is effective for bonds issued after December 31, 1983. With respect to bonds outstanding under qualified bond purchase plans, the bill provides that the present tax rules continue to apply, except that an individual may redeem such bonds without regard to whether he has attained age 59½.

Discussion

We support the bill's repeal of these provisions. Treasury terminated the sales of retirement bonds on April 30, 1982, because sales had become negligible and we do not plan to offer such bonds in the future. In light of this, and considering the relatively low yield that such bonds generally provide, it is appropriate to repeal the governing provisions with respect to future bonds and to authorize the redemption of outstanding retirement bonds so that individuals may rollover the proceeds to IRAs, under which investments with higher yields are available.

Section 902. Repeal of Rules Relating to Gains From Disposition of Property Used in Farming Where Farm Losses Offset Nonfarm Income

Description of provision

Finally, the bill also would repeal the provision, enacted in 1969, that provides for the recapture of certain farm losses taken by taxpayers who used such losses to offset nonfarm income and then later attempted to obtain capital gains on the disposition of the farm. In effect, the recapture rule provides that the gain from the disposition of certain classes of farm property is to be taxed at ordinary, not capital gain, rates to the extent that the taxpayers' post-1969 accumulated farm losses have been used to reduce nonfarm income.

Discussion

We support the repeal of this recapture rule. The Tax Reform Act of 1976 provided that farm losses sustained after 1975 would not be subject to recapture, but instead would be governed by other limitation provisions. As a result, the present recapture rule is relevant only for losses that were incurred between 1969 and 1976 with respect to property that has not yet been sold. We are not aware of any instance in which the recapture provision has a continuing significant effect. On that basis, we support its repeal.

ADDITIONAL SIMPLIFICATION PROVISIONS

We wish to take this opportunity to recommend that the Committee include in the bill several other proposals that would simplify and improve the administration of our tax laws.

Extension of period for assessment

Section 6501 generally limits the period for assessing taxes to three years beginning with the date the return is filed or the due date of the return, whichever is later. This general rule is modified for fraudulent returns, returns involving a substantial omission of income and in several other appropriate circumstances. There is no provision, however, which permits extending the period for assessment solely for purposes of processing an amendment to an original return and assessing additional taxes due.

Present law does not permit the assessment of tax after expiration of the period specified for assessment. Thus, it becomes very difficult to assess additional tax reported on amended returns filed on, or just prior to, the expiration of the period for assessment of taxes on the original return. Without timely assessment, the additional taxes, of course, cannot be collected.

We recommend that section 6501 be amended to provide that if a taxpayer amends an original return to show an increase in tax liability within 60 days of the expiration of the period for assessment of tax, the period for assessment will be extended solely to allow the IRS 60 days from the date the amendment is filed to process the amendment and assess the tax. This change would assure that additional tax due as reported by a taxpayer on an amended return could be assessed and collected.

Certified Treasurer's or Cashier's Checks Issued by Financial Institutions

If a certified treasurer's or cashier's check received in payment of taxes is not duly paid, section 6311(b)(2) provides that the United States has a lien upon all assets of the bank or trust company on which the check is drawn. A lien also is created on the assets of the issuer of a money order. The lien is a preferred claim and consequently permits the IRS to treat such checks as the equivalent of cash for the purposes of releasing a Federal tax lien encumbering a taxpayer's property. The taxpayer retains ultimate liability if the IRS is unable to collect under section 6311(b)(2).

There have been many changes in the activities of financial institutions during the past few years. Mutual savings banks, credit unions and savings and loan associations generally provide checking account services that were not anticipated when section 6311 was enacted. In addition, these institutions may certify checks and issue instruments that are viewed by the general public as equivalent to the traditional cashier's check issued by a commercial bank.

On occasion taxpayers have sought to obtain an immediate release of a Federal tax lien by paying with a treasurer's check from a savings and loan association or similar institution. Since the IRS does not have a preferred claim against the issuer's assets, an immediate release of the lien generally cannot be issued due to the risk of loss to the United States. This situation is inconvenient and embarrassing to the taxpayer, the financial institution and the IRS.

We recommend, therefore, that section 6311(b)(2) be amended to use the term "financial institution" in lieu of "bank or trust company" and the phrase "guaranteed draft (generally referred to as a certified, treasurer's or cashier's check)" in lieu of "certified, treasurer's or cashier's check" each place such term or phrase occurs.

Authorize Disclosure or Windfall Profit Tax Information to the States

Section 6103(d)(1) authorizes the IRS to disclose to State tax agencies returns and return information with respect to income, self-employment, estate, gift and numerous other taxes. The existing statute contains no provision authorizing the IRS to disclose windfall profit tax information to these agencies.

We recommend that section 6103(d)(1) be amended to allow disclosure to the States of returns and return information with respect to the windfall profit tax.

CLOSING STATEMENT

I wish to thank the Committee for giving the Treasury Department the opportunity to present its views on H.R. 3475. We look forward to working with you and your staff to further simplify our tax laws. I would be pleased to answer any questions the Committee might have on this testimony.

Mr. **Flippo** [presiding]. Thank you for your testimony.

Mr. Conable?

Mr. **Conable**. Thank you. I would like to ask you a little about the *Davis* rule. You say as it currently applies, the tendency is for people to transfer appreciated assets and not pay a capital gains tax on them even though that is what the rule says. It is your purpose in supporting this to encourage use of appreciated assets in divorce settlements and to treat them simply as gifts. Therefore, the basis would then carry over to the person receiving the settlement.

Mr. **Pearlman**. Right. That is correct.

Mr. **Conable**. Do you feel that will be a more administrable position? Is that it?

Mr. **Pearlman**. Yes, very much so. I think it is important, Mr. Conable. I don't want to leave the impression that we think that all situations in which appreciated property is transferred are not reported by transferors because of evasion. We think there is a broad based ignorance of this rule. I don't think spouses generally are aware that transfers of property from one spouse to the other might trigger a tax liability.

Indeed I think spouses generally think that even though property is recorded in one spouse's name or the other, that it is jointly owned. Indeed, my wife is convinced that she owns all of my property. On the other hand, we think that if we can eliminate the potential whipsaw, that is desirable.

In addition we do not think there is a major abuse potential here. We do not think that true sales between spouses take place very often. Therefore, we don't think that transfers of appreciated property between spouses is going to raise the possibility of tremendous abuse transactions between the spouses.

Mr. **Conable**. This applies to houses more than anything else I would assume.

Mr. **Pearlman**. It certainly applies to houses and oftentimes it would apply to appreciated securities taken in one spouse's name or the other incident to a marital breakup or split-up or transfer from one spouse to the other in connection with a marital settlement.

Mr. **Conable**. Is it your assessment that it will facilitate property settlements?

Mr. **Pearlman**. Yes absolutely.

Mr. **Conable**. It of course means that the appreciated asset goes to the aggrieved spouse subject to a degree of disability in that the basis remains the same; therefore that spouse, if they dispose of the property, will be subject to capital gains tax which is not the case now. But it does make it easier for the transferring spouse to make the transfer, and presumably to facilitate property settlements from that point of view.

Mr. PEARLMAN. Yes, I think you are absolutely correct. Your comment points out the problem, if one spouse is well advised in a divorce settlement and one spouse is not. If both are adequately represented presumably that shouldn't happen because as part of the negotiating process, the recipient spouse is going to be advised to take into consideration the potential tax liability that will occur when the appreciated property is disposed of.

Mr. CONABLE. Thank you, Mr. Pearlman. I appreciate your testimony.

Mr. FLIPPO. Mr. Duncan?

Mr. DUNCAN. Thank you, Mr. Chairman.

Thank you, Mr. Pearlman.

About a year or so ago the Treasury indicated that we were studying a flat rate tax and promised to give us a report on the study. I don't recall ever receiving it. But there seems to be an increasing interest in the flat rate tax, particularly from middle and lower income people. I know all the members are getting mail on it.

I was wondering if you could tell us what happened to the study; if you have the study is it available to the committee. If not, we would like your own views on a flat tax.

Mr. PEARLMAN. Mr. Duncan——

Mr. DUNCAN. I think the time has been reached where we are going to have to hold hearings or do something to let the people know what it is. It sounds good.

Mr. PEARLMAN. Mr. Duncan, you may be aware, in the late 1970's, Treasury did publish a fairly widely regarded publication called Blueprints on Tax Reform. It did describe both the flat rate tax system and the so-called consumption-based tax system in some detail. There is continuing review of these proposals going on in the Treasury at this time. I am not aware of any target date for providing any further report.

But I will try to respond to that when I get back to the Treasury.

Mr. DUNCAN. Would you care to express your own views on flat rate tax?

Mr. PEARLMAN. Not being an economist and not wanting to hold myself out, Mr. Duncan, as a representative of the administration on this subject, I think certainly we are all interested. I think everyone shares the interest in various systems of taxation that could materially simplify the tax laws. The flat rate tax system certainly is one way to do that. It in a sense would wipe the slate clean and permit us to start afresh.

My own personal concern with the flat rate tax is twofold; *(a)* I am concerned that we will simply start over again. That is, the deductions and credits will start creeping into the statute again. That raises some question in my mind as to whether the flat rate tax is the way to go.

The second thing that I am concerned about is whether the flat rate tax properly evaluates the economic considerations that should go into any broad-based tax reform. Perhaps, for example, the same level of simplification could occur through the adoption of the so-called consumption tax, and yet perhaps some effort to look at the capital needs of this country and the need for infusion of capital in this country might best be met through the consumption tax instead.

But I must tell you, Mr. Duncan, that I don't view economics as my strength. I certainly would hope that my comments wouldn't be viewed as anyone's other than my own.

Mr. DUNCAN. In dealing with domestic problems of couples, as a Congressman, and I think other members have the same problem, we find that a great problem comes up when one has disappeared, usually the man. Then the problem is discovered by Treasury or IRS. Then they can't find the man. The burden goes to the women.

Mr. PEARLMAN. Right.

Mr. DUNCAN. Do you think this will——

Mr. PEARLMAN. We are concerned about that. I unfortunately am coming to you telling you that we are not in agreement with the expansion of the innocent spouse provisions of the code which are intended to deal with that kind of problem. But we are concerned about that problem. We are sympathetic to that problem. We would hope that perhaps the first step which we do recommend, namely, a further relaxation of the ability of the Internal Revenue Service to abate penalties asserted on the spouse who the collector is able to find might aid in those rather sympathetic cases.

Obviously we are willing to work with the committee to try to continue to deal with that problem. We are concerned, on the other hand, that a joint return does impose a joint tax liability on both spouses. While we are sympathetic to the case of one spouse who disappears, I think we also have to be concerned about maintaining the integrity of the joint return concept that is I think heavily embedded in the current tax law.

Mr. DUNCAN. Thank you very much.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you. Are there any further questions? If not, we thank you very much.

Mr. PEARLMAN. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. The Chair calls Mr. Finch.

STATEMENT OF JOHNNY C. FINCH, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY KANE WONG, SENIOR EVALUATOR

Mr. FINCH. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Good morning, Mr. Finch. As you are aware, your entire statement will be included in the record. However, if you would like to summarize your statement, the committee is ready to receive it. You may proceed.

Mr. FINCH. Thank you. With me at the table is Mr. Kane Wong of our office. Mr. Wong was the audit manager who was responsible for the work which led to this testimony.

At your suggestion, sir, I will try to summarize. I can either give you a 10-minute version or 5-minute version, whichever you prefer.

Chairman ROSTENKOWSKI. You make the choice.

Mr. FINCH. Fine.

Mr. Chairman and members of the committee, we are pleased to be here today to provide information for the committee's use in considering H.R. 3475—the Tax Law Simplification and Improvement Act of 1983. Our testimony relates primarily to title I of the bill, and particularly to that portion of title I which pertains to estimated tax penalties assessed on individual taxpayers. However, we would also like to comment on another aspect of the bill that deals with an issue on which GAO has done some work—the repeal of stamp requirements.

Mr. Conable. What?

Mr. Finch. The repeal of stamp requirements, sir. It is a provision of title VI.

As you know, Mr. Chairman, the Federal income tax system is a pay-as-you-go, self-assessment system. Employers are required to withhold income tax on compensation paid to employees in the form of salaries, wages, and tips. For income that is not subject to withholding, or income from which not enough tax is being withheld, individual taxpayers are required to make payments totaling at least 80 percent of their estimated tax in quarterly payments.

Each year, millions of taxpayers are required to make estimated tax payments. A significant number of these taxpayers incur penalties for not making adequate and/or timely payments. In fiscal year 1982, over 6 million such penalties were assessed, amounting to over $800 million.

The present process requires taxpayers to determine if they have met their tax liability through withholding and/or estimated tax payments. If they have not, they use form 2210, "Underpayment of Estimated Tax by Individuals," to calculate the penalty on the amount of the underpayment or to request that IRS abate the penalty on the basis of one of four exceptions shown on the form.

Exception 1, hinges on the tax due for the previous year. If the current year's tax payments equal or exceed the tax shown on the previous year's tax return, the taxpayer is excused from the penalty. The previous year's return must cover a 12-month period and show a tax liability.

Exception 2, hinges on the income for the previous year. If the current year's withholding and estimated tax payments equal or exceed the tax due on the previous year's income computed with the current year's rates the taxpayer is excused from the penalty.

Exception 3, hinges on annualized income. If the current year's tax payments equal or exceed 80 percent of the tax on annualized income for periods from January 1 to March 31, May 31, or August 31, the taxpayer is excused from the penalty.

Exception 4, is based on actual tax due. If the current year's tax payments equal or exceed 90 percent of the tax on the actual income from January 1 to March 31, May 31, or August 31 the taxpayer is excused from the penalty.

Once taxpayers have calculated the penalty, they are to attach the form 2210 to their form 1040 and remit the amount due. If they fail to do this, IRS will compute the penalty and send them a notice of the amount due. With the notice, IRS includes a form 2210 that taxpayers may use to determine if they meet any of the exceptions to the penalty. If the taxpayers find that they qualify for an exception to all or part of the penalty, they must return the completed form to IRS so that the proper adjustment can be made.

Otherwise, the taxpayers must pay the full amount of the penalty as computed by IRS.

In a July 1980 report, we informed the Commissioner of Internal Revenue that taxpayers apparently found the exceptions, the form 2210, and the related instructions so confusing that they preferred to pay the penalty rather than try to determine if they met one of the exceptions. Our opinion was shared by IRS personnel at the Boston district office who told us that many taxpayers asked if they could pay the penalty rather than prepare the form 2210. Our opinion was further supported by available statistics for 1979 which indicated that few taxpayers used the exceptions—less than 5 percent of the 3.6 million taxpayers who were assessed penalties.

Although IRS made some changes to form 2210 and the related instructions, taxpayer confusion was not completely eliminated because the exceptions remained the same. In this regard, title I of H.R. 3475 is intended to simplify the exceptions to the estimated tax penalty. Under the current law, the taxpayer must pay estimated tax payments totaling 80 percent of the current year tax liability, or be subject to a penalty unless the penalty could be excused under one of the four exceptions previously discussed.

The bill would allow the taxpayer to compute the estimated tax payments using one of three methods. Specifically, H.R. 3475 provides that estimated tax payments are to be based on annualized income or the lesser of one, 100 percent of the previous year's tax, or two, 80 percent of the current year tax liability. Thus, the bill would retain, in substance, two of the current exceptions to the penalty—exceptions 1 and 3, but would not retain the other two exceptions—2 and 4. Title I also adds a provision to the code which would allow estimated tax penalties to be abated for reasonable cause.

In anticipation of a legislative proposal affecting the estimated tax provision, staff members of the Joint Committee on Taxation and this committee recently asked us to develop some statistical information to show one, which of the four exceptions excusing taxpayers from paying estimated tax penalties are used the most and two, the characteristics of taxpayers who are incurring estimated tax penalties, including the number of taxpayers assessed penalties who were paying estimated taxes for the first time. We developed this information by sampling tax returns.

I would now like to discuss the preliminary results of our work and our assessment of how the changes proposed by H.R. 3475 would have affected the number of penalties incurred by the taxpayers in our sample. Since the bill would allow IRS to abate the penalty on the basis of reasonable cause, we would also like to discuss our preliminary findings from another study with regard to how IRS is interpreting reasonable cause in abating other types of penalties that are assessed.

In early 1982, IRS studied 6,000 randomly selected individual tax returns for the 1981 tax year to determine whether improvements to forms 1040 and 1040A were necessary. Of the 6,000 returns, 1,200 showed a balance due to IRS. We analyzed those 1,200 returns to determine how many of the taxpayers had been faced with an estimated tax penalty. We found that 600 of the 1,200 tax returns showed that the taxpayers had not paid at least 80 percent of their tax liability and, thus, were subject to an estimated tax penalty.

Of the 600 taxpayers, 250 were required to pay a penalty and 350 were not. The 350 were not required to pay generally because they either understated the tax payments that had been made to IRS, owed an amount that was determined by IRS to be too small to collect, or were excused from the penalty under the exceptions. Overall, 195—32 percent—were excused from the penalty under one or more of the four exceptions.

Basically, exception 1, which deals with prior year tax, was used the most frequently. More than 78 percent of the 195 taxpayers were excused under this exception.

Exception 4, which deals with actual tax, was the next most frequently used. Almost 12 percent of the taxpayers were excused under it.

Exception 2, which deals with prior year income, was less frequently used. About 8 percent of the 195 taxpayers were excused under it.

And, exception 3, which deals with annualized income, was used in only 1 percent of the 195 cases.

To determine the potential effect that H.R. 3475 may have on the number of estimated tax penalties, we applied two of the changes proposed under Title I to the taxpayers in our sample. These two changes are (1) eliminating exceptions 2 and 4, and (2) allowing IRS to abate the penalty on the basis of reasonable cause. In doing this, we assumed that first time estimated taxpayers would be excused from the penalty on the basis of reasonable cause.

We made this assumption because IRS is permitted to consider ignorance of the law, together with other facts, in making abatement decisions on other penalties.

Our analysis showed that the proposed legislative changes would have resulted in a net reduction of 40, or 16 percent, of the 250 penalties assessed in our sample. Specifically, establishing reasonable cause would have decreased the number of penalties by 47, or about 19 percent, but eliminating exceptions 2 and 4 would offset this decrease by 7, or about 3 percent.

We also looked at various characteristics of all 600 taxpayers who were included in our sample—the 250 taxpayers who were required to pay a penalty and the 350 who were not. The characteristics we used were the taxpayers' adjusted gross income and filing status, whether income tax was withheld, and whether estimated tax payments were made.

We found that for two characteristics—adjusted gross income and filing status—there was no significant variation between taxpayers who were and were not penalized. For example, about 35 percent of the 350 taxpayers who were not penalized had an adjusted gross income of under $10,000, while 31 percent of the 250 penalized were at the same income level.

Further, among those penalized, there was no significant variation between those who were to have paid estimated taxes for the first time and those who had been liable for paying estimated taxes in prior years.

For the two characteristics of withholding and estimated tax payments, the only significant difference we noted was that taxpayers who were liable for making estimated tax payments for the first time were most likely to have had some taxes withheld. However, they were also least likely to have made any estimated tax payments.

As you know, Mr. Chairman, H.R. 3475 would permit IRS to abate the estimated tax penalty on the basis of reasonable cause. We are presently studying the manner in which IRS abates civil penalties and our preliminary findings may be of interest to you in considering some of the tax administration implications of this provision. While we have found that IRS is generally doing an effective job, it could improve its performance in interpreting reasonable cause when reaching abatement decisions. Specifically, because IRS guidelines do not sufficiently illustrate the kinds of information needed to support an abatement for reasonable cause, too many penalties are being inappropriately abated and some taxpayers are being treated inconsistently.

The Internal Revenue Code permits IRS to abate most types of civil penalties if the taxpayer shows that failure to file or pay is due to reasonable cause and not to willful neglect.

We found, however, that IRS employees were sometimes granting abatements for reasonable cause without considering whether the circumstances cited by taxpayers actually had a material effect on the timely filing of a return or the payment of taxes. This has resulted in too many penalties being inappropriately abated.

For example, in one of the cases we reviewed, IRS granted an abatement because the taxpayer said that the bookkeeper was on vacation and could not make a timely payment to IRS. The files, however, did not contain sufficient information to demonstrate that the bookkeeper was the only person who could have made the payment.

Because IRS employees do not always obtain and analyze the facts involved, IRS cannot be assured of proper and consistent abatement decisions. To illustrate, we asked 112 employees who made abatement decisions at the locations we visited to judge 10 sample abatement cases using the guidance normally available to them. In only 1 of the 10 cases did more than 70 percent of the employees agree on the disposition of the case.

We plan to make some recommendations to the Commissioner aimed at helping IRS improve its performance in interpreting reasonable cause.

At this point, Mr. Chairman, I would like to briefly discuss title VI of the bill which would repeal the requirement that approved closure devices be used on distilled spirits containers. One such closure device is Government-supplied strip stamps, which the Treasury Department provides free of charge to bottlers and distillers.

In a July 1982 report (GAO/GGD-82-60), we pointed out that strip stamps no longer serve their original purpose of signifying that the tax on the spirits was paid or that the spirits were lawfully bottled. We also noted that use of Government-supplied stamps might be viewed by some as the Government's official endorsement of the product. Given these findings, we recommended that (1) the Government-supplied stamps be eliminated, or (2) the approved closure device requirement be repealed. Either approach would have the effect of saving the Government the $1.7 million it spends annually to print and distribute strip stamps. The bill would fully implement our recommendation.

Mr. Chairman, this concludes my prepared statement. We hope that the committee will find this information useful in considering H.R. 3475. We would be pleased to respond to any questions you may have.

[The prepared statement follows:]

STATEMENT OF JOHNNY C. FINCH, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and members of the committee: We are pleased to be here today to provide information for the Committee's use in considering H.R. 3475—the Tax Law Simplification and Improvement Act of 1983. Our testimony relates primarily to Title I of the bill, and particularly to that portion of Title I which pertains to estimated tax penalties assessed on individual taxpayers. However, we would also like to comment on another aspect of the bill that deals with an issue on which GAO has done some work—the repeal of stamp requirements (title VI).

ESTIMATED TAX PENALTIES

As you know, Mr. Chairman, the Federal income tax system is a pay-as-you-go, self-assessment system. Employers are required to withhold income tax on compensation paid to employees in the form of salaries, wages, and tips. For income that is not subject to withholding, or income from which not enough tax is being withheld, individual taxpayers are required to make payments totaling at least 80 percent of their estimated tax in quarterly payments.

Each year, millions of taxpayers are required to make estimated tax payments. A significant number of these taxpayers incur penalties for not making adequate and/or timely payments. In fiscal year 1982, over 6 million such penalties were assessed, amounting to over $800 million.

The present process requires taxpayers to determine if they have met their tax liability through withholding and/or estimated tax payments. If they have not, they use form 2210, "Underpayment of Estimated Tax by Individuals," to calculate the penalty on the amount of the underpayment or to request that IRS abate the penalty on the basis of one of four exceptions shown on the form.

Exception 1 hinges on the tax due for the previous year. If the current year's tax payments equal or exceed the tax shown on the previous year's tax return, the taxpayer is excused from the penalty. The previous year's return must cover a 12-month period and show a tax liability.

Exception 2 hinges on the income for the previous year. If the current year's withholding and estimated tax payments equal or exceed the tax due on the previous year's income computed with the current year's rates the taxpayer is excused from the penalty.

Exception 3 hinges on annualized income. If the current year's tax payments equal or exceed 80 percent of the tax on annualized income for periods from January 1 to March 31, May 31, or August 31, the taxpayer is excused from the penalty.

Exception 4 is based on actual tax due. If the current year's tax payments equal or exceed 90 percent of the tax on the actual income from January 1 to March 31, May 31, or August 31 the taxpayer is excused from the penalty.

Once taxpayers have calculated the penalty, they are to attach the form 2210 to their form 1040 and remit the amount due. If they fail to do this, IRS will compute the penalty and send them a notice of the amount due. With the notice, IRS includes a form 2210 that taxpayers may use to determine if they meet any of the exceptions to the penalty. If the taxpayers find that they qualify for an exception to all or part of the penalty, they must return the completed form to IRS so that the proper adjustment can be made. Otherwise, the taxpayers must pay the full amount of the penalty as computed by IRS.

In a July 1980 report, we informed the Commissioner of Internal Revenue that taxpayers apparently found the exceptions, the form 2210, and the related instructions so confusing that they preferred to pay the penalty rather than try to determine if they met one of the exceptions. Our opinion was shared by IRS personnel at the Boston District Office who told us that many taxpayers asked if they could pay the penalty rather than prepare the form 2210. Our opinion was further supported by available statistics for 1979 which indicated that few taxpayers used the exceptions—less than 5 percent of the 3.6 million taxpayers who were assessed penalties.

Although IRS made some changes to form 2210 and the related instructions, taxpayer confusion was not completely eliminated because the exceptions remained the same. In this regard, Title I of H.R. 3475 is intended to simplify the exceptions to the estimated tax penalty. Under the current law, the taxpayer must pay estimated tax payments totaling 80 percent of the current year tax liability, or be subject to a penalty unless the penalty could be excused under one of the four exceptions previously discussed. The bill would allow the taxpayer to compute the estimated tax payments using one of three methods. Specifically, H.R. 3475 provides that estimated tax payments are to be based on annualized income or the lesser of (1) 100 percent of the previous year's tax, or (2) 80 percent of the current year tax liability. Thus, the bill would retain, in substance, two of the current exceptions to the penalty—exceptions 1 and 3, but would not retain the other two exceptions—2 and 4. Title I also adds a provision to the Code which would allow estimated tax penalties to be abated for reasonable cause.

In anticipation of a legislative proposal affecting the estimated tax provision, staff members of the Joint Committee on Taxation and this Committee asked us, in April 1983, to develop some statistical information to show (1) which of the four exceptions excusing taxpayers from paying estimated tax penalties are used the most and (2) the characteristics of taxpayers who are incurring estimated tax penalties, including the number of taxpayers assessed penalties who were paying estimated taxes for the first time. We developed this information by sampling tax returns.

I would now like to discuss the preliminary results of our work and our assessment of how the changes proposed by H.R. 3475 would have affected the number of penalties incurred by the taxpayers in our sample. Since the bill would allow IRS to abate the penalty on the basis of reasonable cause, we would also like to discuss our preliminary findings from another study with regard to how IRS is interpreting reasonable cause in abating other types of penalties that are assessed.

Use of exceptions

In early 1982, IRS studied 6,000 randomly selected individual tax returns for the 1981 tax year to determine whether improvements to forms 1040 and 1040A were necessary. Of the 6,000 returns, 1,200 showed a balance due to IRS. We analyzed those 1,200 returns to determine how many of the taxpayers had been faced with an estimated tax penalty. We found that 600 of the 1,200 tax returns showed that the taxpayers had not paid at least 80 percent of their tax liability and thus, were subject to an estimated tax penalty.

Of the 600 taxpayers, 250 were required to pay a penalty and 350 were not. The 350 were not required to pay generally because they either understated the tax payments that had been made to IRS, owed an amount that was determined by IRS to be too small to collect, or were excused from the penalty under the exceptions.

Overall, 195 (32 percent) were excused from the penalty under one or more of the four exceptions. Basically, as shown in Attachment I,

Exception 1, which deals with prior year tax, was used the most frequently. More than 78 percent of the 195 taxpayers were excused under this exception.

Exception 4, which deals with actual tax, was the next most frequently used. Almost 12 percent of the taxpayers were excused under it.

Exception 2, which deals with prior year income, was less frequently used. About 8 percent of the 195 taxpayers were excused under it.

And, exception 3, which deals with annualized income, was used in only 1 percent of the 195 cases.

To determine the potential effect that H.R. 3475 may have on the number of estimated tax penalties, we applied two of the changes proposed under Title I to the taxpayers in our sample. These two changes are (1) eliminating exceptions 2 and 4, and (2) allowing IRS to abate the penalty on the basis of reasonable cause. In doing this, we assumed that first-time estimated taxpayers would be excused from the penalty on the basis of reasonable cause. We made this assumption because IRS is permitted to consider ignorance of the law, together with other facts, in making abatement decisions on other penalties.

Our analysis showed that the proposed legislative changes would have resulted in a net reduction of 40, or 16 percent, of the 250 penalties assessed in our sample. Specifically, establishing reasonable cause would have decreased the number of penalties by 47, or about 19 percent, but eliminating exceptions 2 and 4 would offset this decrease by 7, or about 3 percent. This information is detailed in Attachment II.

Our analysis also showed that the adjusted gross income of taxpayers using exceptions 1 and 4—the two most frequently used exceptions—was almost equally divided above and below $20,000. However, most of the taxpayers using exceptions 2 and 3 had adjusted gross income under $20,000. Attachment III provides this information in more detail.

Characteristics of sampled taxpayers assessed an estimated tax penalty

As shown in Attachment IV, 250 of the 600 taxpayers in our sample were required to pay estimated tax penalties ranging from $1, to $2,457. Over 70 percent of the penalties assessed amounted to less than $100. We also noted that 59, or about 24 percent, of the 250 taxpayers were making estimated tax payments for the first time, and that all but one of these taxpayers were assessed penalties under $300.

We also looked at various characteristics of all 600 taxpayers who were included in our sample—the 250 taxpayers who were required to pay a penalty and the 350 who were not. The characteristics we used were the taxpayers' adjusted gross income and filing status, whether income tax was withheld, and whether estimated tax payments were made.

As shown in Attachment V, we found that for two characteristics—adjusted gross income and filing status—there was no significant variation between taxpayers who were and were not penalized. For example, about 35 percent of the 350 taxpayers who were not penalized had an adjusted gross income of under $10,000, while 31 percent of the 250 penalized were at the same income level. Further, among those penalized, there was no significant variation between those who were to have paid estimated taxes for the first time and those who had been liable for paying estimated taxed in prior years.

For the two characteristics of withholding and estimated tax payments, the only signficant difference we noted was that taxpayers who were liable for making estimated tax payments for the first time were most likely to have had some taxes withheld. However, they were also least likely to have made any estimated tax payments. This information is detailed in Attachment VI.

IRS' experience with interpreting reasonable cause

As you know, Mr. Chairman, H.R. 3475 would permit IRS to abate the estimated tax penalty on the basis of reasonable cause. We are presently studying the manner in which IRS abates civil penalties and our preliminary findings may be of interest to you in considering some of the tax administration implications of this provision. While we have found that IRS is generally doing an effective job, it could improve its performance in interpreting reasonable cause when reaching abatement decisions. Specifically, because IRS guidelines do not sufficiently illustrate the kinds of information needed to support an abatement for reasonable cause, too many penalties are being inappropriately abated and some taxpayers are being treated inconsistently.

The Internal Revenue Code permits IRS to abate most types of civil penalties if the taxpayer shows that failure to file or pay is due to reasonable cause and not to willful neglect. Examples of conditions that IRS considers to be acceptable reasons for granting an abatement for reasonable cause include

Death or serious illness of the taxpayer;
Unavoidable absence of the taxpayer;
Destruction of tax-related records by fire or other casualty; and
Lack of funds despite the exercise of ordinary business care and prudence.

We found, however, that IRS employees were sometimes granting abatements for reasonable cause without considering whether the circumstances cited by taxpayers actually had a material effect on the timely filing of a return or the payment of taxes. This has resulted in too many penalties being inappropriately abated. For example, in one of the cases we reviewed, IRS granted an abatement because the taxpayer said that the bookkeeper was on vacation and could not make a timely payment to IRS. The files, however, did not contain sufficient information to demonstrate that the bookkeeper was the only person who could have made the payment.

Because IRS employees do not always obtain and analyze the facts involved, IRS cannot be assured of proper and consistent abatement decisions. To illustrate, we asked 112 employees who made abatement decisions at the locations we visited to judge 10 sample abatement cases using the guidance normally available to them. In only one of the 10 cases did more than 70 percent of the employees agree on the disposition of the case.

We plan to make some recommendations to the Commissioner aimed at helping IRS improve its performance in interpreting reasonable cause.

STRIP STAMP REQUIREMENTS

At this point, Mr. Chairman, I would like to briefly discuss Title VI of the bill which would repeal the requirement that approved closure devices be used on distilled spirits containers. One such closure device is Government-supplied "strip stamps," which the Treasury Department provides free of charge to bottlers and distillers.

In a July 1982 report (GAO/GGD-82-60), we pointed out that strip stamps no longer serve their original purpose of signifying that the tax on the spirits was paid or that the spirits were lawfully bottled. We also note that use of Government-supplied stamps might be viewed by some as the Government's official endorsement of the product. Given these findings, we recommended that (1) the Government-supplied stamps be eliminated or (2) the approved closure device requirement be repealed. Either approach would have the effect of saving the Government the $1.7 million it spends annually to print and distribute strip stamps. The bill would fully implement our recommendation.

Mr. Chairman, this concludes my prepared statement. We hope that the Committee will find this information useful in considering H.R. 3475. We would be pleased to respond to any questions you may have.

ATTACHMENT I

USE OF EXCEPTIONS

Exception	Number	Percent
1	153	78.5
2	17	8.7
3	2	1.0
4	23	11.8
Total	195	100.0

ATTACHMENT II

POTENTIAL EFFECT OF LEGISLATIVE CHANGE

Proposed change	Effect on all taxpayers	
	Number	Percent
Increase penalties: Eliminate exceptions 2 and 4	7	2.8
Decrease penalties assessments: Reasonable cause-effect on first-time estimated taxpayers	[1] 47	18.8
Net reduction in taxpayers penalized	40	16.0

[1] This figure does not include those first-time estimated taxpayers who would not be assessed a penalty under a provision in the Economic Recovery Tax Act of 1981. This provision, to be fully in effect by 1985, allows taxpayers to avoid an estimated tax penalty when the tax due after credits is less than $500.

ATTACHMENT III

EXCEPTION USAGE BY ADJUSTED GROSS INCOME

AGI	Exception							
	1		2		3		4	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Under $10,000	21	13.7	8	47.0	2	100	4	17.4
$10,000 to $19,999	55	35.9	6	35.3			7	30.4
$20,000 to $29,999	33	21.6	2	11.8			9	39.1
$30,000 to $39,999	13	8.5	1	5.9			2	8.7
$40,000 to $49,999	7	4.6					1	4.4

EXCEPTION USAGE BY ADJUSTED GROSS INCOME—Continued

AGI	Exception 1		Exception 2		Exception 3		Exception 4	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
$50,000 to $59,999	6	3.9						
$60,000 to $69,999	9	5.9						
$70,000 to $79,999	2	1.3						
Over $80,000	7	4.6						
Total	153	100.0	17	100.0	2	100	23	100.0

ATTACHMENT IV

RANGE OF PENALTIES

	First time		Other	
	Number	Percent	Number	Percent
Dollar range:				
$1 to $99	45	76.3	131	68.5
$100 to $199	12	20.3	30	15.7
$200 to $299	1	1.7	11	5.8
$300 to $399			7	3.7
$400 to $499			1	.5
$500 to $999			9	4.8
$1,000-plus	1	1.7	2	1.0
Total	59	100.0	191	100.0

ATTACHMENT V

RANGE OF ADJUSTED GROSS INCOME

[In percent]

	Taxpayers with no penalty	Taxpayers liable for paying estimated tax for first time	Other taxpayers with estimated tax penalty
Dollar range:			
Under $10,000	35.0	30.5	32.4
$10,000 to $19,999	32.6	27.1	31.4
$20,000 to $29,999	15.3	15.2	16.8
$30,000 to $39,999	6.6	13.5	9.5
$40,000 to $49,999	3.6	3.4	2.0
Over $50,000	6.9	10.2	7.9
Total	100.0	100.0	100.0
Filing status:			
Joint	56.0	50.9	55.4
Single	40.2	38.9	38.3
Head of household	2.3	6.8	6.3
Separate	1.5	3.4	0
Total	100.0	100.0	100.0

ATTACHMENT VI

WITHHOLDING AND ESTIMATED TAX PAYMENT

[In percent]

	Taxpayers with no penalty	Taxpayers liable for paying estimated tax for first time	Other taxpayers with estimated tax penalty
Withholding:			
Yes	46.9	64.4	42.9
No	53.1	35.6	57.1
Total	100.0	100.0	100.0
Payment:			
Yes	30.5	11.8	29.3
No	69.5	88.2	70.7
Total	100.0	100.0	100.0

Chairman ROSTENKOWSKI. Thank you, Mr. Finch. We appreciate your observations. I am sure that when we deliberate this legislation we will take your views into consideration.

Mr. Conable will inquire.

Mr. CONABLE. Thank you, Mr. Chairman.

I don't have any specific inquiry about your testimony. But let me ask you about the GAO and its relationship to the tax laws generally.

Do you have a number of ongoing studies of the tax system, both at the request of this committee and of individual Congressmen?

Mr. FINCH. That is correct, we do.

Mr. CONABLE. And do these reports go generally to the Joint Committee on Taxation?

Mr. FINCH. If the Joint Committee requests the study, the report would go directly to the Joint Committee. Even if the Joint Committee did not request the study, they are on our distribution list for each report that we issue that deals with tax administration matters.

Mr. CONABLE. Can you tell me generally how many studies are in progress now?

Mr. FINCH. We presently have about 34 or 35 studies in progress.

Mr. CONABLE. On different aspects of the administration of the tax law?

Mr. FINCH. That is correct.

Mr. CONABLE. I am gratified to hear this.

The Joint Committee on Taxation meets only on rare occasions. I was unsure of the current state of such inquiries.

I think it is important that this committee has available to it investigatory opportunities here in the Congress and information about matters relating to the administration of the tax law. Otherwise we are going to read about it in the paper ultimately to our embarrassment. We should not learn about excessive use of tax avoidance techniques, for instance, from the columnists. We ought to have in-house adequate opportunities to review the operation of the tax law.

This committee is engaged in legislative activity. We do have an oversight branch, but obviously there is a limit to what that subcommittee can do.

Do you generate any investigations at your own behest?

Mr. FINCH. Yes, sir, we do. But for any of those investigations that require access to tax returns or return-related information, Federal law requires that we notify the Joint Committee in advance, 30 days before we begin our work. The Joint Committee then either approves or denies our request for tax information, for purposes of doing that particular job.

Mr. CONABLE. Well, what is the process by which you generate investigations?

Mr. FINCH. We have what we think is a rather sophisticated planning process in terms of deciding where our limited resources can best be spent, what issues are most deserving of our attention.

A major part of that process relates to input from congressional staff. We also attend conferences, we try to keep in contact with experts throughout the country in terms of what issues are breaking in the tax area. We have in fact an ad hoc advisory panel that helps us in the tax administration area, that panel being composed of three former IRS Commissioners and the two most recent former Chiefs of Staff of the Joint Committee on Taxation.

Mr. CONABLE. Thank you for giving me that information. I am somewhat reassured to learn the standards of your investigation on the operation of the tax law.

Thank you.

Chairman ROSTENKOWSKI. Thank you very much, gentlemen.

The Chair calls Judge Dawson. Welcome to the committee.

Congratulations, Judge Dawson, on your new assignment as Chief Judge of the Tax Court. This is your first appearance before our committee. We look forward to receiving your testimony. You may proceed.

STATEMENT OF HON. HOWARD A. DAWSON, JR., CHIEF JUDGE, U.S. TAX COURT, ACCOMPANIED BY HON. JOHN J. PAJAK, SPECIAL TRIAL JUDGE, AND CHARLES CASAZZA, CLERK OF THE COURT

Judge DAWSON. Thank you very much, Mr. Chairman.

I have with me to my right Special Trial Judge John Pajak. I brought him along because about 99 percent of the small tax cases are handled by our 12 special trial judges.

And at my left I have the clerk of the court, Charles Casazza.

Mr. Chairman, I appreciate the opportunity to testify with respect to the provisions of H.R. 3745 relating to the U.S. Tax Court.

As you pointed out in your press release and other statements, a number of the provisions relating to the Tax Court are noncontroversial, and therefore I will not comment specifically on those. There is one, that is the first provision of the bill, which is Section 701 (a) and (b), which do present somewhat controversial provisions.

The Tax Court has submitted a written statement recommending those provisions in the bill, and after some consultation with the judges of our legislative committee—and like most things before the Tax Court, judges are never in complete agreement—we decided to file a statement which indicated that generally we think the provisions of the bill present a fair and balanced approach. However, apart from that statement, I have some very strong personal feelings on this matter, and therefore I would like to make some side comments.

I think that the Tax Court is concerned about the proposed changes involving representation of the parties in small tax cases.

While our statement recognizes the dichotomy between small tax cases and regular cases, and the different considerations that enter into the picture, and that Congress is trying its best to take a fair and balanced approach to this issue, I personally have very grave doubts as to whether it is advisable or necessary.

It is my understanding that this is supposed to be a tax law simplification bill. And I don't think this provision to expand representation in small tax cases to nonlawyers is really going to simplify anything.

It will complicate, not simplify, the procedural aspects for handling such cases and for their disposition. I am afraid that we might throw a monkey wrench into a litigation system that has worked in my judgment efficiently and effectively for 13 years, and will continue to run smoothly if we leave it alone.

I used to tell my grandfather, who was a farmer in southwest Arkansas, that I thought he ought to get some of his farm machinery fixed. He used to respond and say, "Son, if it ain't broke, don't try to fix it." I think the same principle applies here.

I don't say that it is necessary, because I think it is not, to change these provisions. I don't think we should tamper with a small tax case litigation system that has worked without any hitches.

I don't know who conceived the idea that small taxpayers should be allowed to be represented by certified public accountants and enrolled agents. But whoever is responsible for suggesting these provisions has not fully analyzed the history behind the development of the small tax case procedures and how successful that system has worked.

But I do know about it, because I have been involved in it almost from the very beginning, which goes back 15 years ago when Bill Drennen, who was then Chief Judge of the Tax Court, asked me to experiment with certain small tax case calendars, even before there was ever a formal small tax case procedures.

These were the forerunners of section 7463, the present small tax case provisions which, as you know, went into the Tax Reform Act of 1969, and which I might emphasize were proposed by the Court and by the Treasury Department. Certainly one of the driving forces behind these provisions was Martin Worthy, then Chief Counsel of the Internal Revenue Service.

I served as chairman of the Court's ad hoc Committee on Small Tax Case Procedures, and we developed, I think, plain and simple procedures which we discussed with the staffs of the tax-writing committees at that time. That led to the development of a small tax case kit where we have a form petition that is easy to read—it is a lot easier to fill out than medicare forms and things like that—and we have an instruction booklet that is also very plain and direct, which we have been complimented on many times for the straightforwardness of this instruction booklet.

I also, Mr. Chairman, served as the first judge in charge of the Small Tax Case Division of the Court, and I participated in the selection of the first special trial judges who hear virtually all of these cases.

I know what a fantastic job they have done over the years in handling the cases. They now hear cases in over 107 different cities throughout the United States. Many of those cities, like the larger ones, they go to several times a year.

The small taxpayers nationwide I think are given fast, fair, informal hearings close to their homes. The special trial judges assist the petitioners in getting the relevant facts into the record. They explain the law to them, and the rules of evidence are very liberally applied.

I can say without any qualification that we have a system that works and it works well. It is a model program which has been highly praised by the public, by the press, and in publications. As a matter of fact, in the Chicago Tribune a few years ago, when they ran a series of articles on the small tax case procedures, the byline was "The Friendliest and Kindest Court in the Land."

Mr. Chairman, I strongly urge you and the members of the committee to keep this the way it is. I say don't tinker with it.

As the late Justice Oliver Wendell Holmes once said, "A page of history is worth a volume of logic."

If Congress believes that small taxpayers should be represented by nonlawyers, then I say let these groups who may want to provide such representation justify their reasons for it. If there is justification for it, and Congress in its wisdom ultimately enacts section 701(a) of this bill, then of course the Tax Court will do as it has in the past, and make every effort to carry out the congressional mandate.

But we just wanted to express our serious reservations and make them known to this committee, and to urge reconsideration of the real need for section 701(a).

As our statement indicates, we strongly support the provisions of section 701(b), which will eliminate representation in the future by nonlawyers in regular cases.

There are several reasons that are set out on pages 5 and 6 of our statement, and I will not reiterate those reasons now, because I think the statement speaks for itself.

Since the Tax Reform Act of 1969, the U.S. Tax Court has been a court of record under article 1 of the Constitution. Its prior status as "an independent agency in the executive branch of the Government" was removed by that statute. Like other Federal courts in this Nation, the Tax Court should be vested in my judgment with the authority to determine by its own rules, as proposed by the Treasury Department, as to who will be permitted to represent taxpayers in cases before it. Certainly in all regular cases that should be limited just as it is in other Federal courts.

If you want the ultimate form of simplification with respect to representation of the parties in all Tax Court cases, I think it could be accomplished by simply striking the last sentence of section 7452 of the General Revenue Code, and that would leave representation solely within the discretion and control of the Tax Court, where I submit it belongs, and Congress will not be placing itself in the position of sanctioning the unauthorized practice of law by nonlawyers, something which I respectfully submit should be assiduously avoided in all respects.

I fervently hope and believe Congress should let the Tax Court function as a court of record, like all other Federal courts, in controlling the representation of the parties before it.

Now, as I mentioned previously, the remaining provisions of H.R. 3475 relating to the Tax Court are noncontroversial. I think our written statement adequately covers our views. We would like very much to see them enacted with certain minor modifications which have been suggested in our written statement.

I think that concludes my statement, Mr. Chairman. I would be most pleased, along with my colleagues, to answer any questions that you or the other members may have.

[The prepared statement follows:]

STATEMENT OF HON. HOWARD A. DAWSON, JR., CHIEF JUDGE U.S. TAX COURT

Mr. Chairman and members of the committee, I appreciate the opportunity to testify with respect to the provisions of H.R. 3475 relating to the U.S. Tax Court. We hope that the Committee will approve those provisions of the bill, with certain modifications that I will explain in this statement.

Because the Tax Court has a number of proposals for changes to specific sections of the bill, I will discuss separately the Court's views with respect to each section of the bill that affects it.

I. REPRESENTATION OF TAXPAYERS (SECTION 701 OF THE BILL)

We think this section of the bill, which permits representation of small tax case taxpayers by non-lawyers, but permits the Tax Court to eliminate representation by non-lawyers in regular cases, generally provides a fair and balanced approach that recognizes the different considerations that are involved in small tax cases and regular cases.

The purpose of Code section 7463 is to permit taxpayers in cases involving $5,000 or less to elect to have their cases heard under informal procedures that lead to a rapid and fair resolution of the issues. The issues involved in these cases are generally factual, and eliciting the relevant facts is the critical need in most small tax case proceedings. Our special trial judges, who conduct almost all of the trials in small tax cases, actively assist pro se taxpayers in presenting their cases and elicit the facts necessary to decide the cases. Thus we have some doubts as to whether representation by nonlawyers in small tax cases would materially benefit either the taxpayers or the Court. However, since the decisions in such cases are not appealable and are not precedents for other cases, and familiarity with the rules of evidence and court procedure, while helpful, is not essential, the Tax Court has no strong objection to permitting non-lawyers to represent taxpayers in small tax case proceedings. Frankly, we cannot predict whether such representation would have an improved or detrimental effect on settlements, which now result in about 78 percent of the cases filed. We strongly believe, however, that, in the public interest, the right to represent taxpayers in these cases should be limited to certified public accountants and licensed public accountants, and not extended to enrolled agents.

Section 701(a) of the bill would permit any person who is an enrolled agent authorized to practice before the Internal Revenue Service to represent the taxpayer in a small tax case. The Commissioner of Internal Revenue is the taxpayer's adversary in every case before the Tax Court. We urge the Committee not to adopt legislation which would allow the Commissioner of Internal Revenue, the adversary party to the litigation, in effect to control who is entitled to represent the small tax case taxpayer before the Tax Court. We think that to do so would greatly harm the public's perception of the Tax Court as independent of the Internal Revenue Service and thus cause taxpayers to question whether they could receive a fair and impartial hearing in the Tax Court. For these reasons, we urge that the right to represent taxpayers in small tax case proceedings be limited to certified public accountants and licensed public accountants.

In order to permit the court to formulate and publish rules governing representation of taxpayers by the above categories of accountants in small tax case proceedings, we also ask the committee to delay the effective date of section 701(a) of the bill. We suggest that the provision, if enacted, should take effect 6 months after the date of enactment.

We strongly believe that the time has come to eliminate practice by nonlawyers in regular Tax Court cases. Nonlawyers are not permitted to practice in the other Federal courts. There are several compelling reasons why nonlawyers should not be permitted to represent taxpayers in reqular Tax Court cases. They are: (1) the application of the Federal Rules of Evidence in regular cases (Code section 7453); (2) the adoption by the Tax Court of Rules of Practice and Procedure patterned largely after the Federal Rules of Civil Procedure; (3) the complexity of the legal issues involved; (4) the importance in these cases of general legal doctrines regarding, for example, property, contracts, corporations, and trusts and estates; (5) the fact that a nonlawyer cannot continue to represent the taxpayer if the case is appealed.

There are additional compelling considerations that I wish to bring to the committee's attention. Some background information is necessary to the committee's understanding of these. Code section 7452 now provides that no "qualified person" shall be denied admission to practice before the Tax Court on account of his failure to be a member of a particular profession or calling. To ensure that only qualified persons are admitted to practice before it, each year the Tax Court holds a written examination for applicants for admission to practice (other than attorneys-at-law). Administering this examination entails the expenditure of Tax Court funds and of judicial time and resources. Fort the past several years, the Tax Court has retained and paid law professors to prepare and grade the examination. However, the judges of the Tax Court must review and approve the grades given, determine what should constitute a passing grade, and consider any appeals by unsuccessful applicants. Judical time and resources thus are diverted from consideration of cases before the Court.

For the past 5 years, the number of applicants who have taken the written examination, and the number who have passed it, have been as follows:

Year	Applicants	Applicants successful
1978	37	3
1979	47	1
1980	51	6
1981	67	4
1982	38	4

The number of petitions filed by nonlawyers during each of the past 5 calendar years consistently has been less than one-half of 1 percent of total petitions filed, as is demonstrated by the following statistics:

Year	Total petitions filed	Petitions filed by nonlawyers	Percent
1978	14,265	68	0.48
1979	17,627	68	0.39
1980	23,163	75	0.32
1981	31,629	89	0.28
1982	30,164	107	0.35

We think that the expenditure of judicial time and resources in administering the examination is grossly disproportionate to the benefit derived by a few individuals. In light of the very small number of applicants who take the examination, the exceedingly small number who pass it, and the very small number of taxpayers who have been represented by nonlawyers admitted to practice under the examination procedure, neither the continued diversion of judicial time and resources from cases awaiting consideration by the Court nor the further expenditure of Tax Court funds for this purpose is justified.

We therefore urge the committee to adopt section 701(b) of the bill. This provision would strike out the last sentence of Code section 7452, thus permitting the Court to limit admission to practice before it by rule.

II. ANNUITIES TO SURVIVORS OF TAX COURT JUDGES (SECTION 702 OF THE BILL)

We hope that the Committee will act favorably on section 702(a), which would raise the annuity amount to a surviving child of a Tax Court judge to the amount currently in effect under the survivors annuity plan for other Federal judges.[1] The income from investment of the Tax Court survivors annuity fund is projected to be sufficient to fund all annuity amounts provided for under current law plus the increased annuity amounts which would be provided under this provision.

Section 702(b) of the bill would limit the cost-of-living adjustment provided by Code section 7448(s) by prohibiting any increase in excess of the dollar limits on annuities to surviving children provided by section 702(a). The cost-of-living adjustment provided by law in the survivors annuity plan for other Federal judges, after which Code section 7448(s) was patterned, is not so limited.[2] We can perceive no reason for according less favorable treatment to surviving children of Tax Court judges, and therefore urge the Committee not to adopt the amendment to Code section 7448(s) proposed in section 702(b) of the bill.

III. PROCEEDINGS WHICH MAY BE ASSIGNED TO COMMISSIONERS (SECTION 703 OF THE BILL)

The technical change in Code section 7456 proposed in section 703 of the bill, making clear that the Chief Judge may assign cases involving more than $5,000 to commissioners for hearing and proposed opinion, subject to review and decision by a judge of the Tax Court, is very important in terms of clarification of the Court's authority in this regard. We hope that the committee will act favorably on this proposal.

IV. SPECIAL TRIAL JUDGES (SECTION 704 OF THE BILL)

The Court urges the committee to act favorably on this proposal. Since 1976, the Court's rules have used the title "special trial judge", rather than "commissioner". This change was made with the informal approval of the then-chairmen of the House Ways and Means and Senate Finance Committees. It was the court's experience that the "commissioners" of the court often were confused with the Commissioner of Internal Revenue, particularly by pro se taxpayers. In addition, the title "special trial judge" more accurately describes the duties of these judicial officers.

V. PUBLICITY OF TAX COURT PROCEEDINGS (SECTION 705 OF THE BILL)

Code section 7461 now provides that all Tax Court records shall be open to public inspection. This provision calls into question the Tax Court's authority to place records under seal. The court favors the adoption of section 705 of the bill, which makes clear the court's authority to withhold certain information from public inspection.

The bill provides that the Court may make any provision necessary to "prevent the disclosure of trade secrets *or other confidential information* * * *." (Emphasis supplied.) We construe the phrase "other confidential information" to extend to those types of information that the courts of this country historically have refused to disclose, for example, the details of a divorce case, libelous or scandalous statements, financial or competitive information, information the disclosure of which might threaten the safety of a party or person, or other information which, if divulged, might be used for improper purposes.[3]

---

[1] See 28 U.S.C. section 376(h)(1) (B) and (C).

[2] 28 U.S.C. section 376(m).

[3] See *Nixon* v. *Warner Communications, Inc.*, 435 U.S. 589,. 598 (1978), in which the Court stated: "Every court has supervisory power over its own records and files, and access has been denied where court files might have become a vehicle for improper purposes. For example, the commonlaw right of inspection has bowed before the power of a court to insure that its records are not "used to gratify private spite or promote public scandal" through the publication of "the painful and sometimes disgusting details of a divorce case." * * * Similarly, courts have refused to permit their files to serve as reservoirs of libelous statements for press consumption, * * * or as sources of business information that might harm a litigant's competitive standing, * * *." (Citations omitted.)

Mr. Chairman, that concludes my statement. I would be glad to respond to any question.

Chairman ROSTENKOWSKI. Thank you, Judge Dawson.

What is the current number of cases pending before the Tax Court?

Judge DAWSON. The current number of cases now pending before the Tax Court at the end of June of this year was 54,275 cases. I might add 23,600 of these cases were received in the first 9 months of the fiscal year. During that same period, we disposed of 22,305 cases.

Now, for the previous fiscal year, 1982, we received about 30,000 cases and disposed of slightly over 24,000. There is a gap that has been created during the past few years.

Chairman ROSTENKOWSKI. Do you have any suggestions as to what might be done about the backlog.

Judge DAWSON. Well, we have done a number of things ourselves. With respect to the small tax cases, Mr. Chairman, there really is no substantial backlog. We receive about 9,000 small tax cases a year and we dispose of approximately the same number.

Now, during the current year, the first 9 months of this fiscal year, on the small cases we have received 6,400. We have disposed of approximately 8,400.

But the big problem is really in two areas in our workload. The tax shelter cases, as I am sure you are well aware, and where we have about between 16,000 and 17,000 cases pending. And the other area are the so-called tax protester cases, where we have approximately 7,000 cases pending.

We are able to handle the protester cases all right. They can be handled through summary proceedings. The tax shelter cases are highly complicated. What we have tried to do is turn to the early assignment of those cases by groups and get our judges working on them as soon as possible. And we are experimenting with new procedures. But it is a problem, a difficult problem.

Chairman ROSTENKOWSKI. Mr. Conable will inquire.

Mr. CONABLE. Judge, I understand you have discretion in the small cases as to whether or not you will treat them summarily, that is, whether they can be handled as a small case procedure.

Can you give us any idea of how you exercise that discretion generally?

Judge DAWSON. The statute provides that the taxpayer has the option of electing to have his case heard as a small tax case. If he makes that election, then it is automatically heard that way, and as you know, the case is not appealable, and does not have any precedential value.

A large percentage of the cases under $5,000 are small tax cases because the taxpayer has elected that procedure.

Mr. CONABLE. Do you think any purpose would be served by requiring cases under that size to be handled by that procedure?

Judge DAWSON. I personally feel, Mr. Conable, that that would be a good idea. I think that if the Congress saw fit to make those procedures mandatory for cases under $5,000, that we would probably dispose of the cases quicker, certainly just as favorably as we have in the past.

Mr. CONABLE. Would that have a significant effect on your backlog?

Judge DAWSON. It would have some effect, because most of the cases, say 21,000 of the 54,000 that we are talking about, are cases under $10,000. So that if you had a mandatory procedure, I think it would have an advantageous effect on the handling of our cases.

Also, it is possible that this committee could develop some plan to provide for an option out, say, on cases between 5,000 and 10,000, rather than an option in—in other words, automatically all cases under 10,000 would be treated as small cases, but the taxpayer would have the right to take a case that involved more than 5,000 but less than 10,000 out of that procedure.

Mr. CONABLE. You would recommend, then, a mandatory procedure?

Judge DAWSON. Yes, I would. I think that is a good idea.

Mr. CONABLE. Thank you.

Chairman ROSTENKOWSKI. Are there any further questions?

If not, thank you very much, Judge Dawson.

The Chair calls Mr. Aidinoff. Welcome to the committee. As I pointed out with other witnesses, you may summarize your testimony. Your entire statement will be included in the record.

STATEMENT OF M. BERNARD AIDINOFF, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY JAMES JONES, VICE CHAIRMAN FOR GOVERNMENTAL RELATIONS

Mr. AIDINOFF. Mr. Chairman, we have 55 pages. We have no intention at all of boring you with all 55 pages.

Mr. Chairman, I am chairman of the Section of Taxation for 1 more week. I am appearing on behalf of the section.

I am accompanied by John Jones, vice chairman for governmental relations.

The section of taxation enthusiastically endorses the approach of H.R. 3475 to concentrate on specific sections or portions of the code that need improvement or simplification to make our income tax system work more efficiently and more equitably.

There are strong recent precedents demonstrating that Congress can legislate in this responsible manner, such as the Subchapter S Revision Act, and the Installment Sales Act. And we stand ready to work with the committee and its staff to see that H.R. 3475 successfully follows a similar course.

The section of taxation believes that H.R. 3475 is the tax legislation this year to which we as lawyers can make the most constructive and informed contribution.

We have had an opportunity to work on a number of the subjects covered in the bill, and to discuss them at length with the staff. As you know, the printed version of the bill has been available only for about 2 weeks. We have substantial technical comments, but we hope that over the next 30 or 45 days that we will be able to submit additional comments directly to your staff.

I would like to express our views on the particular titles involved.

Title I attacks responsibly some of the major complexities of the present estimated tax provisions. H.R. 3475 provides for the estimated tax penalty and substantive rules to be covered in one section. And just putting that all together in one section is a major contribution.

Keying the quarterly payments for most people to 80 percent of the current year's tax, or 100 percent of last year's tax, preserves the most important flexibility and discards some very complex exceptions.

We believe that the elimination of a fourth exception does simplify the code, that the fourth exception is not particularly valuable, and we disagree with the Treasury about the advisability of retaining it.

Basing the penalty only on the failure to meet the lower of the 100 percent or the 80 percent standards eliminates an unfortunate cliff effect of present law under which a very large penalty could be imposed for a very small miscalculation. The move towards quarterly tax payment is obviously rational, and it is only to be regretted that budget considerations interfere with changing the September 15 installment date to October 15.

Title II is probably the most important portion of the bill and it deals primarily with the tax aspects of divorce and separations. It is really the culmination of many long hours of work by a special task force of the section of taxation working together with the staffs of the Committee on Ways and Means, Finance Committee, and Treasury.

At long last the bill presents a legislative solution to the problems created by the Supreme Court in its 1962 *Davis* decision which made taxable the transfer of appreciated property in a divorce settlement. This alone would be a major accomplishment, but the bill goes on to clarify and greatly simplify the treatment of alimony, to correlate the estate and give tax treatment of interspousal transfers and to provide a much less vexatious and more easily administratable definition of dependency exemption.

The section on taxation strongly supports the intention of all these provisions.

We have set forth in our statement a number of comments which we believe would improve these provisions of the bill, but I do not intend to repeat what is in the statement.

I would like to comment, however, on the statement made by Deputy Assistant Secretary Perlman on the elimination of the periodic payment test. The Treasury seems to oppose that provision in the bill. We of the section of taxation believe what is in the bill, which is basically an elimination of most of the periodic payment test, is a much simpler provision, a much fairer provision, and one which represents more reality in today's situation where couples are more anxious to disengage themselves completely when a divorce or separation is involved.

In many respects, the tax section would have gone further than what is in the bill. But we think that the bill in its present form, in dealing with this question, is an appropriate balancing of interests and one that should be adopted.

With respect to title III, the at risk rules, we believe that there are changes that should be made in this area, and this is an area where the tax section believes more study by it is necessary.

We have a large number of comments. Again, I won't repeat them.

With respect to the estimate and gift tax provision in title IV, the section of taxation supports the adoption of a permanent rule permitting reformation of charitable split interest instruments which fail to meet statutory or administrative requirements. There is no reason to deny a charitable deduction where the testator has done or has made a good faith attempt to comply with the very complicated statutory or administrative provisions and the property in fact goes to charity subject to the proper limitations.

While we applaud the basic provisions in this title, we would probably go further and be more liberal with respect to reformation.

The section of taxation has not adopted a formal position on the proposal in section 402 to eliminate the alternative valuation date election unless the basis of the gross estate and the estate tax liability were both reduced. However, we note this is an obvious simplification, and a return to the original intent to protect estates when value has declined.

While this change may cause some increase in tax, it is balanced by the change which would permit an election in a late filed return provided it is the first filed return. If this change is made, the alternate valuation date election should be permitted for purposes of qualifying an estate under sections 303, 6166, and 2032(a). However, the question of the income tax basis in such a situation perhaps should relate back to the date of death.

Title V deals with the foreign provisions. Last year the ABA adopted a recommendation of the section of taxation to simplify and improve the definition of nonresidential aliens. A copy of our recommendation is attached to the statement. To the extent that section 501 adopts this recomendation, we speak on behalf of the ABA. We have a lot of detailed comments contained in our statement.

With respect to the foreign personal holding company provisions contained in section 503 and 505, we believe changes in this area are necessary. We believe we probably ought to go beyond just tinkering. We think that a preferable approach would be to repeal the foreign personal holding company provisions entirely and make appropriate modifications to the controlled foreign corporation rules.

This step was recommended by Richard Gordon of the Joint Committee staff. And we recommend it to you.

With respect to the proposed amendments to section 1248, in general those are amendments that we support.

With respect to section 506, dealing with stapled stock, we think that with respect to the portion dealing with the stapling together of a domestic corporation and a foreign corporation, rather than treating the foreign corporation as a domestic corporation so that we have two domestic corporations stapled together, our preference would be to treat the foreign stapled stock as if they were a subsidiary of the domestic corporation which would in most cases then treat it as a controlled foreign corporation and eliminate any benefit from the stapling.

With respect to the broad grant of regulatory authority on stapling, we tend to think that this is unwarranted. With respect to stapling in the domestic area, we think that a little more consideration needs to be given to this. There are a substantial number of REIT's out there that have rulings from the Internal Revenue Service, and some consideration in a bill like this needs to be given to the retroactive effect.

And it may be that it may be better to eliminate that provision so as not to be embroiled in this controversy.

With respect to title VII, the Tax Court provisions, we are in agreement with both the Treasury and with Judge Dawson that the question of who should practice ought best be left to the Tax Court. The relationship of the small case procedure to whom should practice is not really a very direct relationship. And I think everyone would be served better by having the Tax Court itself handle this matter.

With respect to title VIII, simplification of income tax credits, this is an extremely important simplification aspect of the bill. It is very, very complex. We do have to be certain that in rationalizing the credits, we rationalize them correctly. We have some comments. We expect that we will have additional comments on that section.

The section of taxation looks forward to working with the staff of the Committee on Ways and Means and with the Joint Committee on this important bill. We are prepared and will work promptly with you in order that you can have the benefit of the comments of the profession.

Thank you.

[The prepared statement follows:]

STATEMENT OF M. BERNARD AIDINOFF, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

OUTLINE OF REMARKS

The Section of Taxation enthusiastically endorses the approach of H.R. 3475 to concentrate on specific sections or portions of the Internal Revenue Code that need improvement or simplification to make the income tax system work more efficiently and more equitably for both the Government and the taxpayer.

The areas selected in H.R. 3475 are each well-suited for non-partisan revenue-neutral improvement and simplification.

The Section of Taxation wishes particularly to call attention to Title II of the Bill, the "Domestic Relations Tax Reform Act of 1983." This title is the culmination of many long hours of work by a special task force of the Section of Taxation, the staffs of the Committee on Ways and Means, the Joint Committee, Finance Committee and Treasury, and members of the AICPA. At long last, there has been developed a legislative solution to the problem created by the Supreme Court in its 1962 *Davis* decision which made taxable the transfer of appreciated property in a divorce settlement. This alone would be major accomplishment, but the bill goes on to clarify and greatly simplify the treatment of alimony, to correlate estate and gift tax treatment of interspousal transfers, and to provide a much less vexatious and more easily administration definition of "dependency exemption."

STATEMENT

I am M. Bernard Aidinoff, Chairman of the Section of Taxation of the American Bar Association. Except as otherwise noted, the views expressed in this statement are those of the Section of Taxation and not those of the Association.

The Section of Taxation enthusiastically endorses the approach of H.R. 3475 to concentrate on specific sections or portions of the Internal Revenue Code that need improvement or simplification to make the income tax system work more efficiently and more equitably for both the Government and the taxpayer. As Chairman Rostenkowski has noted in announcing this hearing, this constructive approach will not work if the bill is laden with other policy changes or provisions to solve the problems of particular taxpayers.

There are strong recent precedents demonstrating that Congress can legislate in this responsible fashion—the Installment Sales Revision Act of 1980 (Public Law 96-471) and the Subchapter S Revision Act of 1982 (Public Law 97-354). We stand ready to work with the committee, its staff and other interested groups to see that H.R. 3475 successfully follows a similar course.

The Section of Taxation believes that H.R. 3475 is the tax legislation this year to which it can make the most constructive and informed contribution. While we have had an opportunity to work on a number of the subjects covered in H.R. 3475 and to discuss them with the staff, the printed version of the bill has been available to our members for barely two weeks. That is simply not enough time for a voluntary association such as ours to collect, analyze and assemble technical comments on the many intricacies involved in the bill's 146 pages. We have received only a few technical comments to date. I hope very much that as our study develops and additional points appear, we can submit them for inclusion in this record and later for discussion with staff.

Having expressed the section's enthusiastic support for the concept and approach of H.R. 3475, I would like to express our views on each of the particular Titles involved:

TITLE I. ESTIMATED TAX

While the section has not taken any position on specific changes in existing law, it is apparent that Title I attacks responsibly some of the major complexities of the present estimated tax provisions.

H.R. 3475 provides for the estimated tax penalty and substantive rules to be covered in one section. This technical change alone will make dealing with these provisions much easier.

Keying the quarterly payments for most people to 80 percent of the current year's tax or 100 percent of last year's tax preserves the most important flexibility and discards some very complex exceptions. Basing the penalty only on the failure to meet the lower of these standards eliminates an unfortunate "cliff" effect of present law under which a very large penalty could be imposed for a very small miscalculation. If properly used, the power to waive the penalty will help to improve respect for the entire estimated tax system. The move toward quarterly tax payment dates is ovbiously rational and it is only to be regretted that budget considerations appear to interfere with changing the September 15 installment date to October 15.

We would point out that H.R. 3475 retains, as under present law, the provision that alternatie minimum tax is not used in calculating either the current year's tax or the prior year's tax for purposes of the exception. Given that the cliff effect is being eliminated, we think some consideration might be given to taking into account the alternative minimum tax in applying the prior year's tax exception. An argument against this might be that the alternative minimum tax is usually paid as a result of the occurrence of an unusual event during the taxpayer's taxable year, and this unusual event should not be taken into account in determining the applicability of an exception under the estimated tax rules. Nevertheless, the exception is based on what the taxpayer already knows about his or her last year's tax, and the alternative minimum tax is not normally a steep tax in any event. Further, the TEFRA changes to the alternative minimum tax broadened its base, making it more nearly a true alternative tax.

TITLE II. DOMESTIC RELATIONS

Title II of the bill relating primarily to tax aspects of divorces and separations is the culmination of many long hours of work by a special task force of the Section of Taxation, the staffs of the Committee on Ways and Means, the Joint Committee, Finance Committee and Treasury, and members of the AICPA. At long last, there has been developed a legislative solution to the problem created by the Supreme Court in its 1962 *Davis* decision which made taxable the transfer of appreciated property in a divorce settlement. This alone would be a major accomplishment, but the bill goes on to clarify and greatly simplify the treatment of alimony, to correlate estate and gift tax treatment of interspousal transfers, and to provide a much less vexatious and more easily administrable definition of "dependency exemption." We strongly support the intent of all of these provisions.[1]

By way of background, it is appropriate to note that since 1980 the Section has been intensively studying the domestic relations tax area, as well as attempting to formulate alternative solutions to a number of serious problems in this area. In carrying out this work, the section has prepared a series of reports; and, in most instances, provisions of the proposed "Domestic Relations Tax Reform Act of 1983" are consistent with recommendations previously advanced by the Section in these reports. Most importantly, title II carries forward one of the Section's most fundamental recommendations—i.e., that changes in the domestic relations tax area should be carried out in a broad, comprehensive manner, as opposed to piecemeal amendments to the Internal Revenue Code.

Set out below are recommendations of the Section for certain changes to Title II or to the Committee's report on the legislation. In several instances, the Section believes that its suggested changes would further simplify the proposed system; and, in these instances, the Section believes that its recommendations are wholly consistent with the basic principles of title II. Further recommendations of the Section are intended to (a) clarify key terms, (b) promote consistency between the income, gift, and estate tax provisions of the Internal Revenue Code, and/or (c) provide suggestions for correlative changes to other sections of the Code.

SPECIFIC RECOMMENDATIONS

Section 202. Treatment of Transfers of Property Between Spouses or Incident to Divorce

In the Technical Explanation to Title II, the scope of the non-recognition rule of proposed Section 1041 is explained in a number of respects. The Section suggests that this explanation be expanded in the Committee's report on the legislation to make clear that if, incident to a divorce, one spouse forgives a debt of the other spouse, Section 1041 would preclude any recognition of income under Section 108 of the Code.

Proposed Section 1041(c) provides for a definition of the concept "incident to divorce" for purposes of determining whether post-divorce transfers are within the scope of the proposed non-recognition rule. This definition provides, in part, that a transfer is within such rule if it is "related to the cessation of the marriage." As the latter phrase possibly entails some ambiguities, the Section recommends that the Committee's report on Title II include an indication that a transfer shall be deemed as "related to the cessation of the marriage" if it is required under the governing instrument or its otherwise "part and parcel" of the ex-spouses' marital settlement. The Section also recommends that the Committee's report make clear that "cessation" of a marriage includes an annulment.

Proposed section 1015(e) indicates that the basis of property for the transferee, which is transferred under the new non-recognition rule, is to be determined under section 1041, not the basis rules for gifts set out in section 1015, even though proposed section 1041(b)(1) speaks of transferred property as otherwise being treated as if "acquired by the transferee by gift." Since most taxpayers do not think of transfers incident to divorce as "gifts," the Section suggests that references in proposed Section 1015(e) to "gifts" be deleted—i.e., that the caption for the proposed section be relabeled as "Transfers Between Spouses" and the phrase in the proposed section "by gift" be deleted.

Section 203. Tax Treatment of Alimony and Separate Maintenance Payments

Proposed section 71(b)(1)(A) provides that in certain circumstances a payment "received by a spouse" will constitute "alimony" for Federal income tax purposes. The technical explanation makes clear that a cash payment to a third party that benefits the spouse shall be deemed as constructively received by the spouse. Because such third party payments are quite common in the divorce area, the Section recommends that the foregoing point from the technical explanation be expressly set out in proposed section 71(b)(1)(A).

Proposed section 71(b)(1)(B) provides that a "divorce or separation instrument" may designate an otherwise "includible/deductible" payment as "excludible/nondeductible." The section strongly supports this approach, as there are many common situations in which this type of flexibility would simplify the tax treatment of settlements for the benefit of divorcing spouses and the government alike. In connection with this provision, however, the Section suggests several refinements. First, it would seem preferable if the statutory language required parties to designate the payments they intend to be "includible/deductible," with such language also providing that all payments outside the scope of the parties' designation automatically being "excludible/non-deductible." This approach should aid in the administration of tax laws by the Internal Revenue Service and the courts, as it would mean that whenever the designation option it utilized a full answer to the question of how much income is taxable to the recipient would be in the governing instrument.

---

[1] At this time, the Section of Taxation does not have a position on the changes in the so-called innocent spouse provisions of the Internal Revenue Code.

Second, in the view of the section, the phrase "divorce or separation instrument" in proposed Section 71(b)(1)(B), which would permit divorce court judges to utilize the designation option, seems overly broad. Many such judges have not had extensive experience in the tax area; and, in practice, many divorce adjudications are hammered out in courts with inadequate time for consideraiton of alternative approaches to tax issues. Altogether, it would seem preferable for the designation option to be available to parties solely by written agreement (irrespective of whether entered into before or after any court rulings), as such an approach would be more conducive to parties more thoroughly analyzing the tax aspects of their settlement.

Third, it would also seem preferable if the designation option were taken out of the definition of "alimony or separate maintenance payment" in proposed section 71(b)(1) and placed in a separate subsection. Even if parties avail themselves of this option, they are likely to think of their spousal support as being "alimony," especially since spousal support concepts are generally based on defined terms under local law. The question for most taxpayers would be whether their spousal support is to be taxable in whole, in part, or not at all under the Code. Thus, a separate subsection for the designation option would preserve the "alimony" label for all payments meeting the definitional requirements of proposed section 71(b)(1), which would seemingly comport better with ordinary views.

Proposed section 71(b)(1)(C) provides, in effect, that alimony treatment is not to be available for payments that, in reality, are in exchange for property. The Technical Explanation makes clear that a relinquishment of support or other marital rights under local law is not intended to be "property" for this purpose. Because of possible confusion in this area, the Section suggests that the committee's report on section 71(b)(1)(C) be expanded so as to make the foregoing point more graphic. Specifically, the section recommends that the committee's report on proposed section 71(b)(1)(C) include an additional clause or sentence stating that, for purposes of section 71(b)(1)(C), a spouse's right under an applicable state equitable distribution or similar law to share in property titled (under local property law) in the other spouse's name is a marital right, not a property interest.

Proposed section 71(b)(1)(F) provides that to be an "alimony or separate maintenance payment" a cash payment must be "one of a series" wherein it is "reasonable to expect" at least 50 percent of the amount payable to be paid more than one year after the date of the first payment. The technical explanation states that the purpose of this rule is to preclude a one-time lump sum payment (or similar payment) from being "disguished" as alimony. In the view of the Section, any merit of section 71(b)(1)(F) is far outweighed by the problems it generates, including the following:

(1) The proposed rule would obliterate includible/deductible treatment for payments in a multitude of common situations. Although the sentence following proposed section 71(b)(1)(F) exempts from the "twelve-months requirement" support payments made pursuant to certain decrees (typically predivorce temporary support orders), the exemption does not cover short-term temporary support arrangements pursuant to either (a) divorce decrees handed down when a divorce is granted but the case is continued for a trial on custody or economic issues or (b) contractually agreed upon short-term support arrangements, predivorce and post-divorce. In the view of the Section, it is inconceivable that this result is intended.

(2) Contrary to an overall purpose of Title II, as stated in the technical explanation, proposed section 71(b)(1)(F) serves to preserve a "periodicity" requirement for alimony as a result of the proposed "one of a series" language. Such a requirement and the "reasonable to expect" and the "at least 50 percent" requirements also inject subjective tests into the alimony rules, especially in cases involving fluctuating amounts for support (e.g., 30 percent of an ex-husband's earned income). As demonstrated by the unfortuate experience under present law, such subjective tests are frequent traps for the unwary, as well as productive of much tax controversy. The effect of proposed section 71(b)(1)(F), therefore, would be to continue these extremely undersirable aspects of present law.

(3) Also contrary to an apparent objective of Title II, proposed section 71(b)(1)(F) flies in the face of local divorce statutes and trends. The comments in the technical explanation imply that a "one-time lump-sum payment" (or similar payment) can never be intended for support. This perception is erroneous, as in the vast majority of states today support needs of one spouse can be and are frequently met, in whole or in part, with a one-time transfer. Moreover, the trend today (particularly if there are no children involved) is for ex-spouses to "disengage" in their relationships with each other; and support to an ex-spouse for a short period—e.g., 6, 12, 18, months—is common. In this regard, the effect of proposed section 71(b)(1)(F) is to militate against Federal tax law harmonizing well with State substantive divorce laws.

One inference that can be drawn from the comments in the technical explanation on proposed section 71(b)(1)(F) is that the proposed rule stems from the notion that it is contrary to sound tax policy for a single one-time lump-sum payment to be accorded "includible/deductible" treatment. The section does not share this view, expecially since it believes that the fundamental tax policy for a basic alimony and separate maintenance rule should be that the taxpayer who consumes the payment(s) should be the one to bear the correlative tax. Moreover, in most cases, a one-time lumpsum payment (or a short-term series of payments) involving a relatively small dollar amount is intended to be solely for the recipient's support. On the other hand, if substantial dollars are involved and the payment(s) are plainly intended to meet both support rights and other marital rights, overall tax revenues to the Government would rarely be reduced anyway, due to "bunching of income" for the recipient. In either case, proposed section 71(b)(1)(F) serves no meaningful purpose in relation to the basic objectives of title II.

Another major weakness of proposed section 71(b)(1)(F) would appear to be the ease with which it could be avoided, particularly in cases in which substantial dollars (and sophisticated parties and/or counsel) are involved. Thus, it would seem that the stituations that the proposed rule is intended to snare would rarely occur, as taxpayers in those situations would simply "draft around" the rule. Realistically, parties for whom proposed section 71(b)(1)(F) would pose the most difficulties are likely to be less substantial and/or less well-advised taxpayers.

Although the point is not explicit in the technical explanation, a possible justification for section 71(b)(1)(F) is that the "drawing out" effect on payments the rule would produce is necessary to provide substance to the immediately preceding provision, proposed section 71(b)(1)(E), which provides, in effect, that no payments are to be includible/deductible unless terminable on the recipient's death. Plainly, if a short period is involved, the significance of the requirement of proposed section 71(b)(1)(E) may not be great, especially if the recipient spouse is relatively young. However, proposed section 71(b)(1)(F) would establish one year as the period beyond which payments would have to be stretched; and, actuarially, 1 year in most cases would have little impact on the probability of a recipient's survival.

In sum, the section believes there is little merit in proposed section 71(b)(1)(F) and that it entails so many detriments that it is the very antithesis of tax simplification. The section strongly recommends that proposed section 71(b)(1)(F) be deleted from title II, and it believes that such a step would lead to no significant problems or abuses for the divorce tax system in the future.

As an alternative recommendation—one that is very much a "second choice" approach and relevant only if it is determined that proposed section 71(b)(1)(F) cannot be deleted—the section would recommend that the sentence following section 71(b)(1)(F) be expanded to refer to all types of "divorce or separation instruments" within the scope of proposed section 71(b)(2) to the extent of support payments pursuant thereto. The objective, of course, would be to exempt from proposed section 71(b)(1)(F) any payment(s) that could successfully meet the support requirement of present law. In the view of the section, it would be unfortunate if this support requirement, which has been the source of so much tax controversy in the past and which is otherwise eliminated by title II, is continued in any form. Nevertheless, the majority of cases that would be inequitably affected by proposed section 71(b)(1)(F), as presently drafted, could easily meet such a support test.

As to other provisions of section 203 of title II, proposed section 71(c) would preclude includible/deductible treatment for child support payments, and the language of this proposed provision appears substantially the same as the present child support provision of the Code—i.e., section 71(b) of current law. An important interpretation of section 71(b) is contained in *Lester* v. *Commissioner,* 366 U.S. 299 (1961). The Technical explanation, however, does not elaborate on proposed section 71(c). The section suggests, therefore, that the committee's report on the legislation indicate that no change is intended in the child support area, including the principles enunciated by the U.S. Supreme Court in the *Lester* case.

Section 204. Dependency Exemption in the Case of Child of Divorced Parents, Etc.

Proposed section 152(e) would establish an allocation system for dependency exemptions for children of divorced spouses, one that involves none of the subjective "support tests" that have led to so much tax controversy under present law. The section strongly endorses the overall apprpoach of section 204 of title II. Proposed section 152(e)(2)(A), however, implies that, if parties wish to allocate a dependency exemption to a noncustodial parent, they must do so irrevocably for all future years. As a practical matter, for various reasons, some divorcing spouses prefer to alternate claiming a dependency exemption, particularly if they have only one child. The section recommends, therefore, that proposed section 152(e)(2)(A) be revised to allow parties more flexibility in allocating an exemption and that proposed section 152(e)(2)(B) be revised to require attachment of a copy of the requisits written declaration to the noncustodial parent's return each year such taxpayer claims an exemption.

Section 204(c) would amend sections 143 and 2(b) of the Code so as to provide rules consistent with section 44A for a definition of taxpayers "married but living apart." Under current law, a taxpayer who is ostensibly "married and living apart" might meet the definition under 143 but fail to be able to use head-of-the-household filing status or to take the earned income credit.

An example will suffice to show the unfair complexities that a low income taxpayer may face. Suppose the taxpayer was separated from her spouse who moved out of the house on April 1, and from that point on she maintained the household for the child. Although she would be entitled to the child care credit, she would still be considered married (and thus not eligible for head-of-the-household status) because the missing spouse was not absent for the entire year. Even if the spouse had been absent for the entire year, the abandoned spouse would be considered unmarried under 143, but could not be considered head-of-the-household since she did not maintain the abode for the entire year. Such complexity is unwarranted. There is no reason why an abandoned spouse should not be treated in a consistent manner for purposes of the definition of marital status, filing status, and the child care credit.

The problem this section addresses is primarily one for low and middle income taxpayers. Although high income taxpayers must occasionally use the provisions for "married taxpayers living-apart" during transition years, it is generally only low and middle-income taxpayers who must work with the abandoned spouse tests on a long-term basis since a costly divorce is out of the question. There is ample evidence that the complexity of often-used provisions, such as those in question, is a major cause of noncompliance for low income taxpayers because they cannot afford tax return preparation assistance.

Section 206. Deduction Allowed Against Estate Tax for Transfers Satisfying Section 2516

Proposed section 2043(b) entails an amendment extending the rules of section 2516 in the gift tax area into the estate tax area, which would serve to generally make consistent the gift and estate tax rules in the divorce area. For three reasons, the section suggests that section 206 of title II be expanded to include certain substantive amendments to section 2516. First, in light of the unlimited marital deduction in the gift and estate tax areas enacted in 1981, section 2516 is no longer needed to exempt pre-divorce transfers from gift tax. Second, the present requirement of section 2516, that execution of the agreement precede the severance of marital ties, poses difficulties in a number of cases, since in recent years it has become fairly common for a couple to disolve their marriage and then negotiate over (or litigate on) the economic issues, a sequence that renders section 2516 inapplicable. Third, as drafted, the proposed amendments to the estate tax provisions in section 206 would still leave gift and estate tax rules inconsistent with proposed income tax rules. Accordingly, the section's recommendation is that section 206 of Title II be revised to include an amendment to section 2516 that would entail an incorporation by reference of key terms in proposed section 1041(a)(2), which refers to a "former spouse," and in proposed section 1041(c), relative to a transfer being "incident to divorce." Under this proposal, any post-divorce transfer subject to non-recognition under the income tax rules of proposed section 1041 would also be exempt from gift and estate taxes. Thus, maximum consistency between the income, gift, and estate tax provisions of the Code would be achieved.

Correlative Changes to Other Code Sections

In the time available to it since introduction of H.R. 3475 on June 30, 1983, the section has tentatively concluded that a number of areas interrelate with title II and probably need appropriate correlative changes, particularly to provide coordination for the new nonrecognition rule in the income tax area. The list set out below, of course, is not intended to be exhaustive; and the section will continue to analyze various provisions of the Code to determine whether further recommendations are appropriate.

1. *Section 47:* In the investment credit area, several issues are presented. In particular, for investment credit purposes, the term "disposition" includes a gift, as is indicated in Reg. Sec. 1.47-2(a)(1). Since proposed section 1041(b)(1) provides that any transfer of property within the scope of the new nonrecognition rule should be treated for income tax purposes as a "gift," it would seem that an amendment to section 47 would be necessary to preclude any recapture of investment credits previously taken on assets transferred in a marital settlement. Further, the concept of "cessation" in the investment credit area also poses some questions. More specifically, even if a transfer per se does not trigger a recapture of an investment credit, in some cases an asset might be transferred and in the hands of the transferee no longer constitutes "section 38 property." In this connection, the section submits two alternative recommendations. First, so as to maximize simplicity in the divorce tax area, the section recommends consideration be given to precluding any recapture of investment tax credits on transfers of assets under the nonrecognition rule, even if a particular asset ceases to be "section 39 property." Alternatively, if it is determined that a recapture tax is appropriate, the section recommends that such a tax be imposed upon the transferor, even though theoretically the asset is in the hands of the transferee when it ceases to be "section 38 property."

2. *Section 219(b)(4)(B):* This provision, relative to retirement savings, refers to "qualifying alimony" as amounts includible under section 71(a)(1) of the Code. As a mechanical change, if title II is enacted, section 219(b)(4)(B) should be changed to refer to section 71(b)(2)(A).

3. *Section 408(d)(6):* This section, relative to a transfer of certain accounts incident to divorce, is a nonrecognition provision. To this extent, it would seem appropriate for it to be amended, with the legislative history to the amendment making it clear that the change is appropriate since the new nonrecognition provision of section 1041 adequately covers a transfer of an account, such as an IRA, incident to divorce.

4. *Section 453:* Several changes in the installment sale area appear appropriate. In particular, section 453 should be amended to make clear that installment sale treatment is inapplicable to any transfer of an asset from one spouse to the other in exchange for payments over a period in excess of one taxable year. In other words, section 453 should be revised to make it clear that the nonrecognition rule of section 1041 would override any provision of section 453. In addition, section 453B, relative to dispositions of installments obligations, should be amended to provide that any transfer of an installment obligation under section 1041 would be an exception to the basic rule, so that such a disposition would not be treated as a taxable event. Further, as a mechanical change, the caption to section 453(g) should be amended to eliminate the reference to "spouse."

5. *Section 483:* Although decisional law has made clear that the imputed interest rules of section 483 are not applicable to transfers in a divorce settlement, it would seem appropriate for this principle to be codified with an appropriate amendment to section 483. Such an amendment, however, should not preclude parties from agreeing to pay interest on installment payments if they choose to do so.

6. *Section 1245:* Section 1245(b)(1) provides that transfers via gift are not subject to the basic recapture rule of section 1245(a). Reg. Sec. 1.1245-4(a)(1) refers to this exception for gifts, but this regulation also refers to gifts as being transfers for which basis is determined under section 1015 of the Code. In title II, proposed section 1015(e), however, provides that basis of an asset transferred within the scope of proposed section 1041 shall be determined under section 1041(b), not section 1015 of the Code. It would seem appropriate, therefore, for section 1245(b)(1) to be expanded to refer to transfers under section 1041, as well as gifts.

7. *Section 1250:* A change to section 1250 that corresponds to the proposed change to section 1245 would seem appropriate. Section 1250(d)(1) provides that gifts are not subject to the basic section 1250 recapture rule, but Reg. Sec. 1.1250-3(a)(1) simply refers to Reg. Sec. 1.1245-4(a). The appropriate change would be for section 1250(d)(1) to be expanded to refer to transfers under section 1041.

8. *Section 7701(a)(17):* This provision defines "husband" and "wife" for purposes of sections 71, 152(b)(4), 215, and 682 of present law. Title II eliminates "husband" and

"wife" from proposed sections 71 and 215, and the section recommends that the same approach be used with respect to sections 152(b)(4) and 682. Section 7701(a)(17) should then be revised to provide that the term "spouse" includes a "former spouse" in appropriate cases.

TITLE III. AT-RISK RULES

The Section of Taxation has at present no position on title III which would revise the "at risk" provisions, particularly as they apply to partnerships and Subchapter S corporations.

The current ITC at-risk rules might be considered to be flawed in at least two major respects [2] which are not addressed by H.R. 3475. First, the rules hit investments made in connection with legitimate business activities well outside the tax shelter target area. Individuals and other persons operating small but profitable businesses often buy equipment with seller financing. They also tend to raise borrowed capital from relatives to buy needed equipment. These relationships cause the credit initially to be denied even where the price paid is demonstrably fair, or where the seller or related-party loan is a bona fide obligation which the business owner has every intention of repaying. Second, the current ITC at-risk rules in effect apply to property on an item-by-item basis. By comparison, the section 465 at-risk rules, which are also aimed at "highly leveraged tax shelter activities," if applicable, limit only net losses from a business activity, which may involve more than one qualifying property acquired at different times and operated independently of each other. It may be desirable to address these technical problems at this time.

Some technical comments

1. Seller financing may be treated under the Bill as "nonqualified nonrecourse financing." Where the property in question has a readily ascertainable fair market value (e.g., a new automobile or truck) the seller financing should not disable the owner from obtaining the credit if the property otherwise qualifies. Such seller financing should be treated instead as a loan from a "qualified person."

2. The Bill would provide that the term "qualified commercial financing" does not include "any convertible debt," presumably on the ground that the lender would have an interest in the activity other than as a creditor. However, otherwise qualified debt convertible to less than a 10-percent equity interest in the owner should be included in the "credit base." Assuming that such a conversion option were exercised, such a lender would not be considered to be a "related person" and, hence, would be a "qualified person" for purposes of determining whether the loan constitutes "qualified commercial financing."

3. The bill does not correct a technical flaw in the current ITC at-risk rules pertaining to active leasing businesses. In the case of lessor activities, a third-party guarantee (by the seller, or by the lessee's parent company or through a lessee-arranged standby letter of credit) of the lessee's obligations under the lease may be treated as a guarantee protecting the lessor "against loss," thereby causing the lessor's at-risk investment in the property to be considered to be "nonrecourse financing." The bill should be refined to allow third-party guarantees of the lessee's obligations so long as the lessor is personally obligated to repay any debt incurred with respect to the property. (Cf. IRS Private Letter Rulings 7836029 and 7848033).

4. The Bill contemplates that midcourse increases and decreases in the "nonqualified nonrecourse financing" with respect to the property in question will permit additional ITC amounts "as of" the year the property was placed in service, or require recapture of ITC amounts previously allowed, as the case may be. These adjustment provisions presumably must be squared with the ITC basis adjustment provisions of section 48(q), which are difficult to understand "as is." The resultant complexity in the tax law may not be well received by taxpayers. It also would be at odds with the bill's simplification objectives.

5. The bill would, as does current law, extend the ITC at-risk limitation to "closely held" corporations. Any corporation with fewer than 10 shareholders would be treated as "closely held" for these purposes. A corporation with 10 or more shareholders would be so treated, if five or fewer shareholders directly or indirectly own more than one-half of the value of the corporation's stock during the last half of the year in which the property is placed in service. The bill should treat the nonqualified nonrecourse financing of a closely held corporation as having been decreased to zero in a taxable year in which the corporation's stock ownership changes to a point

---

[2] See generally Karzon & Coffin, "Extension of the At-Risk Concept to the Investment Tax Credit: a Shotgun Approach to the Tax Shelter Problem," 1982 Duke L. J. 847.

where it is no longer considered to be "closely held." Conversely, where a corporation becomes closely held less than 1 year after the otherwise nonqualified nonrecourse financing in question was incurred, the change in status should be treated as an "increase" in nonqualified nonrecourse financing resulting in a recapture of any previously allowable ITC. However, where the change in status occurs more than 1 year after the debt was incurred, it should be treated as a transfer of debt not resulting in an "increase" in nonqualified nonrecourse financing.

TITLE IV. ESTATE AND GIFT TAX PROVISIONS

The Section of Taxation supports the adoption of a permanent rule permitting reformation of charitable split interest instruments which fail to meet statutory or administrative requirements. There is no reason to deny a charitable deduction where the testator/donor has made good faith attempt to comply with very complicated statutory or administrative provisions and the property in fact goes to charity subject to the proper limitations.

The present version of section 401 is more complicated, and therefore less equitable, than it needs to be. It creates qualifications and tests which are not necessary to protect the integrity of the tax expenditure. For example:

(a) For any instrument drawn after 1978, reformation is allowable only if it passes a "good faith test" under section 2055(e)(3)(C)(ii) (requiring adoption of the fundamental pattern of section 664). Any later instrument which through ignorance or incompetence does not follow the section 664 pattern cannot be reformed. Unfortunately, experience shows that a significant number of charitable trusts are still being drafted by general practitioners who do not conform the trusts to section 664. Since the resulting tax burden will usually fall on charity in such cases, it seems inconsistent with the spirit of the provision to insist on a 1978 cut-off date.

(b) The definition of "reformable interest" (clause (ii) of section 2055(e)(3)(C)) does not include a pooled income fund (described in section 642(c)(5)) and a charitable lead trust. Each of these types of trusts is subject to continually evolving technical requirements and has the same need for a reformation process as charitable remainder trusts. As noted in the Technical Explanation, charitable lead trusts were included in the last extension of the current section 2055(e)(3).

(c) A "qualified reformation" (section 2055(e)(3)(B)) can have only a 5 percent change in the value of the charitable interest. Many defects (technical and otherwise) render the charitable interest incapable of valuation by the accepted methods. Such interests are among those most in need of reformation (see Rev. Rul. 82-128 requiring the governing instrument to contain a death tax clause). When the deduction is limited to the pre-reformation value of the charitable interest (section 2055(e)(3)(E)), there appears to be no need to restrict the degree of change in the values. An increase in the charitable interest benefits only charity and the limitation on the deduction precludes "juggling" to take advantage of differentials in rates. It should be noted that a change occurring as the result of a qualified disclaimer under section 2518 is recognized for purposes of allowing an increased charitable deduction.

(d) When the degree of change in actuarial values is regulated or the charitable deduction is limited to the original value (or both), it is difficult to find a need for section 2055(e)(3)(B)(ii) which permits no change in the term of various interests. Such a requirement adds additional complexity without doing anything to make the tax expenditure any more efficient.

(e) In addition to the Code sections amended by section 401, sections 642(c)(5) and 664 should also be amended to give recognition to a qualified reformation.

(f) The Technical Explanation stated that the statute of limitations for closed estates would be reopened until December 31, 1985. This provision does not appear in section 401.

(g) It is not clear whether section 2055(e)(3)(G) requires that the statute of limitations have 1 year to run when the Secretary is notified or whether this provision is intended to amend section 6501. If the latter, it would seem better to amend section 6501 and provide a cross-reference in section 2055(e)(3). Section 6511 should have a provision applying to refunds resulting from qualified reformations.

The Section of taxation has not adopted a formal position on the proposal in section 401 to eliminate the alternate valuation date election unless the basis of the gross estate and the estate tax liability are both reduced.

However, we note that this is an obvious simplification, and a return to the original intent to protect estates when values decline. While this change may cause some increase in tax, it is balanced by the change which would permit an election in a late-filed return provided it is the first filed return. If this change is made, the alternate valuation date election should be permitted for purposes of qualifying an estate under sections 303, 6166 and 2032A. However, the question of the income tax basis in such situations perhaps should relate back to date of death.

TITLE V. FOREIGN PROVISIONS

In 1982, the American Bar Association adopted a recommendation of the Section of Taxation to simplify and improve the definition of "nonresident alien" within the Internal Revenue Code. A copy of that recommendation is attached to this statement. The provisions of section 501 of H.R. 3475 have obviously been developed in the same spirit. To the extent that these provisions are substantially similar to our legislative recommendation, I support them on behalf of the American Bar Association, subject to the following detailed comments.

Detailed Comments

A. Section 501: Definition of resident alien

1. Substantial presence test.—Section 7701(b)(2) would provide that an individual shall be treated as a resident alien with respect to the current calendar year if the sum of the number of days on which such individual was present in the United States during the current year and the two preceding calendar years equals or exceeds 183 days (the "substantial presence test"). For this purpose, the number of days present in the first preceding year is multiplied by two-thirds and the number of days present in the second preceding year is multiplied by one-third. This can lead to some rather strange results. For example, an individual who is present in the United States only 92 days (or approximately 3 months) in each of three consecutive calendar years could be treated as a resident alien individual with respect to the third calendar year. Further, an individual present in the United States for 183 days in each of the two preceding calendar years could be treated as a resident with respect to the current year even if he is never present in the United States during the current year. To avoid results such as these, two changes should be made. First, days present in the first preceding year should be multiplied by one-third and days present in the second preceding year should be multiplied by one-sixth; thus, an individual would not be treated as a resident alien if he was present in the United States for less than 122 days (or approximately 4 months) in each of 3 consecutive years. Second, days present in the United States in preceding calendar years should be taken into account only if the alien individual is present in the United States during the current year for at least 92 days; thus, an alien individual who is present in the United States for less than 92 days in the current year would not have to consider his presence in the United States during preceding calendar years.

2. Exempt individuals.—Section 7701(b)(3) would exempt an individual from the substantial presence test only if such individual were a (i) foreign government-related individual, (ii) teacher or trainee, or (iii) student. In order to allow for a multitude of different fact situations as well as adapt to changes in the immigration laws, it is suggested that a fourth category be added at the end of section 7701(b)(3)(A) to exempt an individual who is: "(iv) described in such other class of individuals as the Secretary may designate by regulation or ruling."

3. Students.—Section 7701(b)(3)(F)(ii) would end the exemption from the substantial presence test for a student for any calendar year after the fifth calendar year for which such individual was exempt either as a student or as a teacher or trainee "unless such individual establishes to the satisfaction of the Secretary that such individual does not intend to permanently reside in the United States and that such individual meets the requirements of subparagraph (E)(ii)" [relating to substantial compliance with the requirements for being admitted as a student]. The quoted language seems superfluous in light of (i) section 7701(b)(3)(B) which provides generally that an individual may not qualify as an exempt individual if the facts and circumstances indicate that such individual intends to permanently reside in the United States, and (ii) section 7701(b)(3)(E)(ii) which provides generally that a student will not qualify as an exempt individual unless such student substantially complies with the requirement for being admitted as a student. Further, 5 years seems long enough to exempt a student from the substantial presence test.

4. Limitation on indirect consequences of residency.—The consequences of being classified as a resident alien go beyond subjecting an individual's worldwide income to United States taxation. Classification of an individual as a resident alien can result in (i) treatment of a foreign corporation as a controlled foreign corporation under section 957 or a foreign personal holding company under section 552, (ii) imposition of the accumulated earnings tax under section 531 or the personal holding company tax under section 541, and (iii) application of the grantor trust rules under section 679; such consequences may affect not only the United States income taxation of the individual but that of other taxpayers. In order to preclude the substantial presence test from having such drastic results, it is suggested that the following special rule be added as new subsection 7701(b)(2)(D):

"(D) EXCEPTION FOR CERTAIN INDIRECT TAXES.--For purposes of applying the provisions of section 531, 541, 551, 679, or 957, to the extent the application of such section depends in part on the classification of an individual as a resident alien, an individual shall not be treated as meeting the substantial presence test of this paragraph with respect to any current year unless such individual was treated as a resident of the United States (without regard to this subparagraph) for each of the two preceding calendar years."

Thus, an individual would not be treated as a resident by reason of the substantial presence test for purposes of these indirect taxes unless such individual were a resident for each of the 2 preceding calendar years.

5. Technical correction.—Section 7701(b)(7) authorizes the Secretary to prescribe regulations under which an individual who would meet "the 183-day presence test of paragraph (2)" is required to submit an annual statement. It seems that the quoted phrase should be "the substantial presence test."

6. Effective date.—Section 7701(b) is effective for "taxable years beginning after December 31, 1983." Assuming that the substantial presence test is modified to take into account days present in the United States in preceding calendar years only if the individual is present in the United States during the current year for at least 92 days, the legislative history should make it clear that for purposes of computing the substantial presence test, days present in calendar years prior to the effective date of section 7701(b) will be taken into account. Similarly, for purposes of the 5-year limit on the exemption for students from the substantial presence text and the 2 out of 6-year limit on the exemption for teachers and trainees from the substantial presence test, calendar years prior to the effective date should be taken into account.

B. Section 502: Treatment of community income

Section 502 would deny a nonresident alien the benefit of splitting income with his or her nonresident spouse under the community property laws of their domicile. We have no position on this proposal but offer a technical comment. Section 879 already provides similar treatment when the wage earner is a resident alien and the spouse a nonresident. However, in that case, the spouses are permitted to file a joint return under 6013(g), since one of the spouses is a resident of the United States. This is important because the Internal Revenue Code imposes a penalty rate of tax on a married individual filing a separate return. For example, the 1982 tax on a married couple with income of $50,000 would be approximately $13,300, the tax on a single individual with taxable income of $40,000 would be approximately $16,300, but the tax on a married person filing a separate return on the same income would be about $18,700. Consideration should be given to allowing the nonresident alien a section 6013(g) election or some other relief from the burden of Schedule Z.

C. Foreign personal holding company provisions: Sections 503, 505

1. Proposed amendments.—The bill would change the treatment of foreign personal holding companies in several respects. Section 505 would amend section 951(d) of the Code to eliminate the rule of present law that the foreign personal holding company rules completely displace the controlled foreign corporation provisions in overlap situations. This would prevent taxpayers from manipulating these rules to avoid taxation under the controlled foreign corporation rules by generating a relatively small amount of taxable foreign personal holding company income, since, under the new overlap rule, the shareholders would, in effect, be taxed on the greater of the amounts determined under the two sets of rules. Section 503 of the bill, which would change the treatment of stock owned by related foreign persons or entities, would conform the foreign personal holding company rules more closely to the controlled foreign corporation rules in this respect.

2. Comment on amendments.—While these changes represent substantial improvements, a piecemeal approach of simply tinkering with the foreign personal holding company rules leaves in place two completely separate regimes to deal with the same problem. The amendments eliminate some of the arbitrary distinctions between these regimes and the potential for minipulation. The remaining differences are still largely a matter of historical accident. Morever, the closer conformity between the two regimes under the proposed amendments makes it even more difficult to justify the complexity of having two different sets of rules, returns, etc.

A preferable approach would be to repeal the foreign personal holding company provisions entirely, with appropriate modifications to the controlled foreign corporation rules. This step was recommended by Richard Gordon, special counsel for international taxation, in a recent report to the IRS and the Treasury on tax havens. "Tax Havens and Their Use by United States Taxpayers" at 141-2 (January 12, 1981).

D. Section 504: Amendments to section 1248 (section 504)

1. Double income inclusion: (a) Background.—While section 1248(a) treats the shareholder as having received a dividend from accumulated earnings of a controlled foreign corporation, there is no explicit mechanism in the statute to treat the corporation has having paid a dividend and adjust its earnings and profits accordingly.[3] As a result, subsequent distributions by the foreign corporation to the purchaser of the stock made out of earnings and profits previously taxed to the selling stockholder under section 1248(a) are technically section 301 dividends, subject to tax a second time.

The failure to coordinate the computation of the earnings and profits of the foreign corporation with section 1248 ordinary income treatment has an additional effect. Income which is included in the disposing shareholder's income under section 1248 "as a dividend" also carries with it the indirect foreign tax credit of section 902. Treas. Reg. section 1.1248-1(d). However, since no adjustment of the foreign corporation's earnings and profits is made, a subsequent distribution of those earnings and profits to the purchasing shareholder would also technically carry with it a credit for the foreign taxes paid on those earnings and profits. Thus, as a corollary to the double inclusion of the earnings and profits, the present statutory structure allows a double crediting of foreign taxes paid with respect to the same accumulated earnings and profits.

(b) Proposed amendment.—Section 504(a) of the bill would cure the double inclusion and double foreign tax credit problem by in effect treating the amount included in the income of the disposing shareholder under section 1248(a) as subpart F income. More precisely, the provisions of section 959 excluding previously taxed earnings and profits from gross income when actually distributed would also apply to subsequent distributions of earnings and profits which have been included in income of the disposing shareholder under section 1248(a). The amendment would thus allow the purchasing shareholder to withdraw and earnings and profits with no second imposition of tax and no doubling up of foreign tax credits.

The amendment also allows a purchasing shareholder subsequently receiving a distribution to take advantage of the increase in the section 904 limitation on the foreign tax credit provided by section 960(b). The shareholder can thus credit any potential foreign withholding taxes imposed on the actual distribution of the previously taxed earnings and profits.

(c) Evaluation of amendment.—While the Section of Taxation has taken no formal position, the amendment seems a desirable cure for serious technical defects in the present statutory structure. There is obviously no policy reason for the double inclusion of the earnings and profits in the income of both the selling and purchasing shareholders. Treating the income included under section 1248(a) as subpart F income for these purposes eliminates the problem of double inclusion and double foreign tax credit in a straightforward and effective manner.

2. Avoidance of section 1248 through indirect ownership: (a) Background.—Section 1248(c)(2) taxes a United States shareholder who disposes of the stock of a foreign corporation on the earnings and profits of any second-tier subsidiaries as well as the earnings and profits of the foreign corporate parent.

This provision prevents avoidance of section 1248(a) treatment on interests held indirectly. Here, Congress clearly had in mind the pattern of a U.S. shareholder disposing of stock of an existing foreign holding company which had stock interests in other foreign second-tier corporations. The statute, however, contains a technical defect which arguably allows use of this anti-avoidance provisions aimed at indirect holdings to avoid section 1248(a) treatment on direct holdings.

Under a literal reading of section 1248(c)(2)(D), the earnings and profits of the second-tier corporation are taxed only to the extent that they were accumulated during periods in which the U.S. shareholder indirectly owned the stock of the second-tier corporation. As a result, a U.S. shareholder can arguably avoid the operation of section 1248(a) on stock of a foreign corporation which it has held directly by exchanging it for stock of a second controlled foreign corporation and then disposing of that stock. There is a technical argument that the amounts treated as dividend income under section 1248(a) do not include the earnings and profits of the now second-tier subsidiary since they were accumulated while the U.S. shareholder held the subsidiary directly rather than indirectly.

---

[3] The Internal Revenue Service has taken the position that section 1248(a) does not affect the earnings and profits of the foreign corporation. See Rev. Rul. 71-388, 1971-2 Cum. Bull. 314.

(b) Proposed amendment.—The proposed amendment would clarify section 1248(c)(2)(D) and eliminate this technical argument by changing the reference in section 1248(c)(2)(D) from section 958(a)(2) to section 958(a), which covers both direct and indirect ownership.

(c) Evaluation of amendment.—The tax avoidance plan to which the amendment is directed rests on an extremely technical reading of the statute which a court may be unwilling to accept. Nonetheless, it seems desirable to have the problem explicitly regulated by the statute and the proposed amendment accomplishes this result.

E. Section 506: Stapled stock

A new section 269B would be added to the Code which would provide, inter alia, that if a domestic corporation and a foreign corporation are stapled entities, the foreign corporation shall be treated as a domestic corporation.

The technical explanation accompanying H.R. 3475 states that this legislation is directed at widely held domestic corporations which have attempted to avoid the application of the provisions relating to tax-haven type activities (presumably sections 951 through 964 of the Code) and the rules relating to international boycotts (section 999 of the Code) by splitting off their foreign operations and conducting them through a separate foreign corporation the stock of which is stapled with the stock of the domestic corporation. If so, it would seem far simpler to treat the domestic corporation as owning the stock of the foreign corporation with which its stock is stapled. Indeed, the case law suggests that in a proper case this result would obtain without resort to a specific statutory provision. See, e.g., *de Coppet* v. *Helvering,* 108 F.2d 787 (2d Cir. 1940) (ownership of stock in bank entitling shareholders to share in dividends and cash distributions of investment corporation treated as a single investment where shareholders' rights with respect to investment company were inseparable from their ownership to bank shares); *Earl R. Wilkinson,* 29 T.C. 421 (1957) (transfer by bank of stock of subsidiary to trustee for bank shareholders not a dividend distribution to shareholders where beneficial interest in subsidiary stock was locked in with bank stock and could not be disposed of separately).

By treating a foreign corporation as a domestic corporation if both are stapled entities, other ancillary questions are presented. For example, if a foreign corporation becomes a stapled entity, is its transformation into a domestic corporation a section 368(a)(1)(F) reorganization with a possible toll charge under section 367(b)? If, conversely, a foreign corporation ceases to be a stapled entity and thus is no longer treated as a domestic corporation, has a transfer of assets to a foreign corporation occurred which requires clearance under section 367(a)? To avoid these and other complications arising from any provisions which deems a foreign corporation to be a domestic corporation, it is suggested that section 269B(a)(1) be deleted. To the extent existing case law is perceived to be inadequate, the Treasury could proceed under section 269B(b) which would authorize the Secretary to prescribe regulations pursuant to which one stapled entity may be treated as owning the other stapled entity to the extent of the stapled interest.

The broad grant of regulatory authority in new section 269B(b) seems unwarranted at present, since the use of stapled entities appears to be limited to a small, specialized group of taxpayers. Broad grants of regulatory authority should be reserved for more pervasive types of tax avoidance, such as those sections 269 and 482 are aimed at. In any event, the statutory language should be modified to make it clear that the regulatory authority is limited to avoidance which results because an entity is stapled.

While the Section of Taxation has taken no position on these provisions, we suggest that sections 502-507 have far-reaching effects which may not yet have been fully considered.

TITLE VI. MISCELLANEOUS ADMINISTRATIVE PROVISIONS

The Section of Taxation has at present no views to express on title VI.

TITLE VII. TAX COURT PROVISIONS

Section 701 would allow CPA's and enrolled agents to appear before the Tax Court under the small case procedure. The existing examination requirements of non-attorneys would be eliminated, but such persons would not be permitted to appear before the Tax Court in regular cases. This provision is very important to the Section of Taxation and its members. To a certain extent, the proposal conforms to current practice where formal representation requirements are waived in small tax cases. This practice has no doubt been part of the reason for the success of small case procedure in helping the Tax Court reduce its docket. On the other hand, there is pressure to increase the sized limit for the small case procedure. The size limit on small cases should not become a jurisdictional battleground between attorneys and other taxpayer representatives. These issues need exploration before the Section of Taxation will be able to express a view. Since our Council will be meeting later this week in Altanta, I hope to be able to submit a written statement of our position within the next 2 weeks.

While the Section of Taxation expresses no views on the remaining provisions of title VII, they are generally consistent with other provisions which we have supported which have been adopted over the years to avoid discrimination against Tax Court pensions and to provide greater flexibility in Tax Court procedure.

TITLE VIII. SIMPLIFICATION OF INCOME TAX CREDITS

Title VIII, dealing with income tax credits, also constitutes a badly needed attempt to rationalize and simplify an important part of the Code. Numerous tax credits, each intended to encourage or stimulate a particular type of endeavor, or relieve a perceived burden, have been added piecemeal to the Code over the years. The result has been inconsistency in such important aspects as limitations on the amount of credit and applicable carryover and carryback rules. We agree that harmonizing these provisions would be an important step toward simplification of the Code. The subtleties of this area, however, demand very careful and thorough deliberation, and the Tax Section has not yet had the opportunity to formulate its position with respect to the specific proposals set forth in title VIII.

We note that under the revised scheme, the personal credits will be taken before the foreign tax credit, the nonconventional fuels credit, the clinical testing credit, and the general business credit. Giving priority to the personal credits makes sense, because they are nonrefundable and, with the exception of the residential energy credit, may not be carried over or carried back to other taxable years. With the exception of the credits for nonconventional fuels and clinical testing, the other credits are either refundable or may be carried over or carried back to other taxable years. The revised system of priorities would therefore appear to lessen the likelihood that a taxpayer will be unable to avail himself of a credit to which he would be entitled but for applicable limitations.

New section 25 adds a limitation on general application to the nonrefundable personal credits. As under current law, the aggregate amount of personal credits may not exceed the taxpayer's tax liability. Section 25, however, adds a new limitation to the utilization of the credit by requiring the exclusion of a number of special taxes from the determination of the taxpayer's liability. These exceptions generally parallel those found in section 53(a), relating to the targeted jobs credit, and it may be appropriate to apply the same exceptions to the personal credit. The committee should be aware, however, that these exceptions are more likely to result in the loss of utilization of a personal credit than of a business credit, because of the lengthy carryover rules applicable to the business credits. Moreover, we note that the exceptions generally include minimum tax provisions or penalty taxes, but that the special section 402(e) tax on lump sum distributions from a qualified plan is also included. That is certainly not the only provision of the Code granting favorable tax treatment to a particular type of income, and the reason for its inclusion in the list of taxes which may not be offset by the personal credits (or, for that matter, the business credits) is therefore unclear.

The combination of the business credits into a single credit is a major step toward simplification. The application of a single set of limitations and carryover and carryback rules will greatly enhance ease of administration. We would suggest that simplicity might be enhanced even further if the fuel production and orphan drug credits were included in the general business credit. We must acknowledge, however, that there are currently no carryover or carryback provisions applicable to those two credits, and that we have no way of assessing the revenue impact of such a change.

We would also point out that the goal of simplicity is not achieved without cost to taxpayers. The dollar limitation which would be applicable under the general business credit would be 100 percent of the first $25,000 of tax liability, plus 85 percent of tax liability in excess of $25,000. This limit constitutes a reduction of the limit previously applicable to the alcohol fuels tax and research and development credits (previously, 100 percent of tax liability), and the employee stock ownership credit (previously 100 percent of the first $25,000 of tax liability plus 90 percent of the excess). The new limit is identical to the limit previously applicable to the investment tax credit, and depending on circumstances, could be either greater or less than the limit previously applicable to the targeted jobs credit (90 percent of tax liability). On the other hand, tax credit utilization will be enhanced by application of a FIFO rule for determining the chronological order in which credits from different taxable years are usable and by the addition of a three year carryback period for the alcohol fuels credit. Nevertheless, the Committee might consider whether a limit of $25,000 plus 90 percent of the tax liability in excess of $25,000 would be a more appropriate balance between the varying provisions of current law, as well as being more equitable to taxpayers who have planned their conduct on the basis of higher credit limits. This question is made more significant in view of the transition rule which applies the new limit to amounts carried back to prior years as well as to amounts carried forward from prior years. It is entirely possible that reducing the limitation applicable to specific credits could completely upset the economics of certain tax-sensitive transactions, such as leveraged leases.

We noted that the special rules of new section 38(c)(3) appear to have been drawn from the current applicable investment tax credit rules. We would point out, however, that the rule for controlled groups permits the Secretary to issue regulations dictating the method by which the $25,000 amount would be apportioned among the component members. This provision is somewhat inconsistent with the analogous provision in section 1561(a), which permits the members of the controlled group to devise their own plan for dividing certain tax benefits.

TITLE IX. DEADWOOD PROVISIONS

It is certainly important to all users of the Internal Revenue Code that obsolete provisions be removed from the Code as soon as possible. H.R. 3475 is an appropriate vehicle. The Section of Taxation has adopted no position on the two provisions (farm losses and bond plans) addressed in Title IX, but it may be significant that in the brief period the bill has been available, no adverse comments to their elimination have been received. If we uncover information about other obsolete provisions, we shall certainly inform your staff.

Title V Attachment—ABA 1982 Proposal on Definition of Nonresident Alien

SECTION OF TAXATION REPORT TO THE HOUSE OF DELEGATES—RECOMMENDATION

Resolved that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to provide a definition of the term "nonresident alien individual" for income tax purposes, pursuant to which (i) aliens will be treated as residents if they are present in the United States for 183 days or more during the taxable year, unless they have closer connections to a specific foreign country than to the United States, with a visa requiring foreign residence being presumptive proof of closer connections to a foreign country unless the alien was present in the United States for 183 days or more during each of the two immediately preceding taxable years, (ii) aliens will be treated as residents if they are admitted for permanent residence in the United States for immigration purposes and they either are present in the United States for 45 days or more during the taxable year while so admitted, or were residents of the United States under the 183 or 45 day rule at any time during either of the two immediately preceding taxable years, (iii) the residence status of an alien for a taxable year will not begin until he is first present in the United States during such year unless he was a resident of the United States at any time during the two immediately preceding taxable years, and (iv) aliens will be considered to be outside the United States throughout a day if outside the United States at the beginning and at the end of the day but will be considered to be present in the United States for a full day in all other cases of presence for a partial day.

Further resolved that the Section of Taxation is directed to urge on the proper committees of the Congress amendments which will achieve the foregoing results.

REPORT

Summary

Sections 871 and 872 provide special rules for the taxation of nonresident alien individuals. However, there is no statutory definition of the term "nonresident alien individual." The regulations provide a definition based upon the subjective intent of the individual. This definition has resulted in substantial uncertainty in practice. There are different rules for the taxation of resident and nonresident aliens, and the lack of definite standards for determination of residence has led to difficulties in application by aliens and by the Internal Revenue Service.

It is recommended that a statutory definition of the term "nonresident alien individual" be provided for income tax purposes, based primarily on objective standards rather than subjective intention. Under the definition, aliens would be residents if they are present in the United States for 183 days or more during the taxable year, unless they have closer connections to a specific foreign country than to the United States. A visa requiring foreign residence would be presumptive proof of closer connections to a foreign country unless the alien was present in the United States for 183 days or more during each of the two immediately preceding taxable years. Aliens would also be residents if they are admitted for permanent residence in the United States for immigration purposes and they either are present in the United States for 45 days for more during the taxable year while so admitted or were residents of the United States under the 183 or 45 day rule at any time during either of the two immediately preceding taxable years. An alien would not become a resident for a taxable year until he is first present in the United States during such year unless he was a resident of the United States at any time during either of the two immediately preceding taxable years.

Aliens would be considered to be outside the United States throughout a day if outside the United States at the beginning and at the end of the day but would be considered to be in the United States for a full day in all other cases of presence for a partial day.

Discussion

The Code imposes a tax on the worldwide income of resident aliens but taxes the income of nonresident aliens only to the extent it is from United States sources or is effectively connected with the conduct of a trade or business in the United States.

Section 872 limits the gross income (and indirectly the taxable income, the alternative minimum taxable income, the tax preferences, and the ordinary income portion of a lump sum distribution) of a "nonresident alien individual" to income which is derived from sources within the United States or which is effectively connected with the conduct of a trade or business within the United States. Section 871(a) imposes a 30 percent tax on specific types of United States source income received by a nonresident alien individual to the extent such income is not effectively connected with the conduct of a trade or business within the United States. Section 871(b) states that a nonresident alien individual is taxable under sections 1, 55 and 402(a)(1) only on effectively connected taxable income. Reg. Section 1.57-0 applies the same principle to section 56.

Section 6013(g) provides that a nonresident alien individual who is married to a citizen or resident of the United States may elect to be treated as a resident of the United States. Section 6013(h) provides that an individual who was a nonresident alien individual at the beginning of any taxable year but a resident at the close of such year and who is married to a United States citizen or resident at the end of such year may elect to be treated as a resident of the United States for such year.

Despite this elaborate structure, the Code provides no definition of the term "nonresident alien individual." The definition has been left to the regulations and to the courts.

Reg. section 1.871-2(a) defines the term "nonresident alien individual" as "an individual whose residence is not within the United States, and who is not a citizen of the United States." Reg. section 1.871-2(b) contains the following definition of "residence":

An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient is determined by his intentions with respect to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but, if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he comes has been consummated or abandoned. An alien whose stay in the United States is limited to a definite period by the immigration laws is not a resident of the United States within the meaning of this section, in the absence of exceptional circumstances.

Reg. section 1.871-4 states that an alien is presumed to be a nonresident. This presumption however, may be rebutted by proof.

(1) that the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws;

(2) that the alien has filed Form 1078; or its equivalent, claiming United States residency; or

(3) of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that this stay in the United States has been of such an extended nature as to constitute him a resident.

In the case of an alien who presents himself for determination of tax liability before departure from the United States, items (1) and (2) must have occurred at least six months before the date he presents himself.

The presumption of Reg. section 1.871-4 has not been accorded much weight by the courts. It has the effect of requiring the Internal Revenue Service to rebut the presumption with some evidence of residence. However, the taxpayer still has to counter the evidence and prove that he is a nonresident alien. *Lemery* v. *Commissioner,* 54 T.C. 480 (1970), acq. 1970-2 C.B. xx.

Reg. section 1.871-3 indicates that in the case of an alien seaman residence may be established on a vessel regularly engaged in coastwise trade, but the mere fact that a sailor makes his home on a vessel which is flying the United States flag and is engaged in foreign trade is not sufficient to establish residency in the United States, even though the vessel, while carrying on foreign trade, touches at United States ports. The regulation also indicates that an alien seaman may acquire an actual residence in the United States under the normal rules even though the nature of his work requires him to be absent for long periods from his place of residence.

Residence is not equivalent to domicile. A person may acquire a residence in the United States for income tax purposes, even though he does not intend to reside permanently in the United States and has a domicile elsewhere. *Maclean* v. *Commissioner,* 73 T.C. 1045 (1980); *Commissioner* v. *Nubar,* 185 F.2d 584 (4th Cir. 1950), cert. den. 341 U.S. 925 (1951). The question of residence is one of fact, with each case decided on its own facts and circumstances. *Dillin* v. *Commissioner,* 56 T.C. 228 (1971); *Adams* v. *Commissioner,* 46 T.C. 352 (1966). Residence requires both actions and intent. To become a U.S. resident, intent alone is not sufficient. *de la Begassiere* v. *Commissioner,* 31 T.C. 1031 (1959), aff'd 272 F.2d 709 (5th Cir. 1959).

The Internal Revenue Service has indicated that living in the United States for one year or more raises a presumption of residence, although this presumption can be rebutted by facts and circumstances showing that the alien is really a transient. Rev. Rul. 69-611, 1969-2 C.B. 150.

Once an alien acquires residence in the United States, he retains that residence until he abandons it and actually leaves the United States. Reg. section 1.871-5.

The basic definition of residence quoted above in Reg. section 1.871-2(b) indicates that an alien whose stay in the United States is limited to a definite period by the immigration laws is not a United States resident in the absence of exceptional circumstances. As a consequence the immigration status of an alien is very important in determining whether the alien is a resident or nonresident. To understand the significance of this provision in the regulations it is necessary to have a basic understanding of the immigration laws.

The Immigration and Nationality Act (8 U.S.C. 1101 et seq.) provides a comprehensive scheme for the admission and exclusion of aliens. Aliens may be admitted under either immigrant or nonimmigrant status. Admission of immigrants for permanent residence is controlled by a selection system and numerical limitations. Nonimmigrants are admitted if they fall within one or more of thirteen subparagraphs of Section 101(a)(15) of the Immigration and Nationality Act, as amended (8 U.S.C. 1101 a-15), which set forth the classes of nonimmigrant aliens. Five of the subparagraphs require that the alien have a residence in a foreign country which he has no intention of abandoning, i.e., subparagraph (B) (visitors for business or pleasure), subparagraphs (F) and (M) (students), subparagraph (H) (those persons performing exceptional services or services which cannot be found in the United States or trainees) and (J) (participants in educational programs designated by the State Department). The other eight subparagraphs relate to (A) officials of recognized foreign governments, (C) those in transit to United Nations headquarters, (D) crewmen on vessels and aircraft, (E) treaty traders entitled to enter under a treaty of commerce and navigation, (G) members of certain international organizations, (I) representatives of foreign information media, (K) aliens marrying United States citizens, and (L) certain workers in a managerial or executive capacity or with specialized knowledge. Most categories also include spouses and minor children.

It is believed that most affected individuals have no professional tax advisors. Those who do have advisors can receive very little practical guidance. The law is so uncertain with respect to such wide category of cases that many taxpayers end up arranging their affairs on the basis of business and personal convenience, and then reporting their income as residents or nonresidents, whichever produces the lesser tax.

The Internal Revenue Service cannot ascertain the facts from the typical tax return and clearly cannot ascertain the alien's subjective intention. Aliens who can claim to be nonresident normally do not even file returns. This puts a large audit burden on the Service. Moreover, auditing is not typically productive. Even if the Service does ascertain the facts in a particular case, the subjective intention standard is so difficult to apply that litigation is often the only way to resolve the case.

More objective rules would provide guidance to the alien, and would aid the Internal Revenue Service in the efficient administration of the tax law. A vague definition of residence may have been adequate 50 years ago when the maximum income tax was under 10 percent and travel to the United States was occasional. However, now that the maximum federal income tax rate is 50 percent and foreigners can reach the United States in a few hours many times each year, a more precise definition is appropriate.

A particular problem is created by the statement in Reg. section 1.871-2(b) that an alien whose stay is limited to a definite period by the immigration laws is not a resident in the absence of exceptional circumstances. As a consequence of this statement, virtually all nonimmigrant aliens can take the position that they are not United States residents—no matter how long they stay in the United States, how close their ties are to the United States and how negligible their ties are to foreign countries.

The problem with the present state of the law is illustrated by the case of *Brittingham* v. *Commissioner*, 66 T.C. 373 (1976). roberta Brittingham was a Mexican citizen who claimed to be a nonresident alien. She was born in the United States in 1891, moved to Mexico in 1896, and became a. citizen of Mexico in 1943. For 24 years, from 1945 to 1968, Mrs. Brittingham maintained and regularly lived in an apartment in Beverly Hills, California. She was seen there often by the mail carrier who delivered her mail for over twenty years. Her name was listed in the Los Angeles telephone directory. From 1963 to 1966, an average of three phone calls per month were made from her son's offices in Dallas to her telephone number in Beverly Hills. In 1965, the State of California (which has a 183-day rule) required Mrs. Brittingham to file California resident income tax returns for 1960 and 1963. She filed timely resident returns in California for 1964-6, stating on each return that she was a nonresident alien of the United States. She was apparently in the United States on a tourist visa.

The Service claimed deficiencies and penalties from Mrs. Brittingham totaling about $2,000,000 for the seven-year period from 1960 through 1966. The court found that twenty years of almost continuous presence was sufficiently permanent to classify her as a resident. The requisite "exceptional circumstances" existed to overcome the presumption of nonresidence contained in the regulations.

Although in *Brittingham* the presumption of nonresidence was overcome and penalties were assessed, it is surprising that there was any question as to her status. In 1965 California succeeded in establishing that she was a resident of California, but it was another eleven years before she was determined to be a resident of the United States. The final result of the litigation in *Brittingham* suggests that consideration be given to making the federal test more objective.

The Recommendation would provide a statutory definition of the term "nonresident alien individual." The proposed statute has two basic parts.

First, it is provided that an alien is a resident of the United States if he is present in the United States for 183 days or more in a taxable year, unless throughout the year he has closer connections to one specific foreign country than to the United States. This rule applies to all aliens, whether or not lawfully admitted to the United States, and whether or not lawfully admitted for permanent residence.

Second, an alien admitted for permanent residence in the United States for immigration purposes (a green card holder) is a resident of the United States for that portion of the taxable year during which he holds a green card if he is present in the United States 45 days or more during the year while holding the green card. He would also be a resident for that portion of the year if he was a resident of the United States under the 183- or 45-day rule at any time during either of the two immediately preceding taxable years. Since a green card holder should generally be considered a resident for tax purposes, the 45-day test is proposed to allow nonresident status only for those green card holders who have minimal contact with the United States.

The special rule making a green card holder a resident if he was a resident under the 183- or 45-day rule during either of the two immediately preceding years is intended to make it difficult for a resident alien to become a nonresident without giving up the right to permanent residence for immigration purposes. It is possible for an alien who holds a green card for only part of a taxable year to become a resident at an earlier time under the 183-day rule.

The Recommendation includes a special burden of proof rule applicable to aliens who have a particular visa status. The rule applies to aliens who have visas which require as a condition of issuance a determination that the alien have a residence in a foreign country which he has no intention of abandoning. Such visas include (B) (business visitors and tourists), (F) and (M) (students), (H) (exceptional services and trainees) and (J) (participants in certain educational programs). The rule provides that proof of such visa status shall be sufficient proof that the alien has closer connections to a specific foreign country than to the United States unless the Service or the alien proves to the contrary by the preponderance of the evidence. The rule does not apply if the alien was present in the United States for 183 days or more during each of the preceding two taxable years. This rule is modeled after section 533(a), dealing with the accumulated earnings tax.

The "closer connections" test is left deliberately vague, in order to allow for a multitude of different fact situations. All facts and circumstances are to be taken into account in applying this test. The test is applied to only one foreign country, so that an alien who had significant connections to each of several foreign countries which in the aggregate outweighed his connections to the United States would not meet the test if his connections to the United States were closer than to any one of those countries. An alien who is an official of a recognized foreign government with a visa issued under section 101(a)(15)(A)(i) or (ii) of the Immigration and Nationality Act would normally have closer connections to that country than to the United States. (The salary of such an official is exempt from taxation under section 893, but other income is not exempt.) Factors to be taken into account include residences, vacation houses, business interests, social clubs, friends, relatives, employment, time spent, bank accounts, citizenship, and treatment by the foreign country as a resident.

Under the recommendation, a return is required to be filed by any alien who is present in the United States for 183 days or more during a taxable year unless a return would not be required if the alien were a resident. Thus any alien who takes the position that the "closer connections" test applies will have to file a return.

The recommendation includes a special rule that an alien may not become a resident of the United States for a taxable year until the first day during such year he is present in the United States, unless he was a resident of the United states at any time during either of the two immediately preceding taxable years. This special rule is intended to allow an alien who moves to the United States before July 1 in a year to avoid Federal income tax on income received before he moves, such as gain on the sale of his home.

For the purpose of counting days of presence in the United States, the recommendation provides that presence in the United States during part of a day is considered to be presence for a full day. However, if the alien is not present in the United States at the beginning or end of a day, any presence during that day is ignored.

The recommendation would abolish the rule of Reg. section 1.871-2(b) that residence depends on the alien's subjective intentions regarding the length and nature of his stay. In its place the recommendation would provide rules which are largely objective. The main purpose is to make the standards more definite. By making the rules clearer there will inevitably be significant changes in the conclusions reached in individual cases.

The statute would not provide any statutory rules applicable to estates or trusts. Reg. section 1.871-2(a) now provides that the term "nonresident alien individual" includes a nonresident alien fiduciary. Estates and trusts are subject to tax only on their undistributed income. Resident estates and trusts are taxed on worldwide undistributed income. Nonresident estates and trusts are taxed on undistributed income to the extent that nonresident aliens are taxed. It is generally felt that the law which has developed to distinguish between resident and nonresident estates and trusts present fewer problems than the law applicable to individuals.

In addition, the statutory definition would have no application to the estate tax, the gift tax or the tax on generation-skipping transfers. The terms "resident" and "nonresident" have been interpreted under these taxes as referring to domicile instead of residence. The general intent of the Recommendation is to provide more objective rules, not to change the concept completely.

The reference in the statute to the "United States" refers to the States and the District of Columbia. In this context the term does not include Puerto Rico, Guam, Samoa, the Virgin Islands or any other United States possession.

The statute would be subject to past and future treaty obligations, including tax treaties, treaties of friendship, commerce and navigation, diplomatic and consular conventions, the Vienna Convention, the United Nations Charter, the Bretton Woods Agreement, agreements creating various other international organizations, particularly those headquartered in the United States, such as the World Bank, Inter-American Development Bank, Organization of American States, Intelsat, and the like, as well as implementing United States legislation.

Many tax treaties provide, for instance, that an individual who is a resident of each contracting state under its law shall for purposes of the treaty be treated as being a resident of only one contracting state, with the state determined under a series of "tie-breaker" rules. Even if the proposed statute operated to cause an individual to be a resident of the United States, the individual might still be treated as a nonresident of the United States under an applicable treaty with another contracting state if the individual were a resident in the other state under its laws and the tie-breaker provision operated to favor such other contracting state.

No member of the originating committee or of the Council of the Section of Taxation is known to have a material interest in the Recommendation by virtue of a specific employment or engagement to obtain the result of the Recommendation. It is recommended that the amendment be given only prospective application. In that case, clients would not be affected in any pending matter.

Chairman ROSTENKOWSKI. Thank you very much. Are there any questions of Mr. Aidinoff?

Mr. CONABLE. Thank you for a very detailed statement. We appreciate it.

Mr. FRENZEL. I thank you for your testimony. You mentioned early on in the testimony that you thought the change from June 15 to July 15 was a nice one, and it would be even better if you could take it from September to October 15. Then you cited the Treasury testimony saying we could not do so because it would kick revenue from one fiscal year into the next.

My question is, are you not doing the same thing when you move June 15 to July 15 for most of the States who operate on a fiscal year closing June 30? Most of the States like to harmonize their tax laws with Federal. If there is a date for payment, they like to have theirs the same. I think there would be a great pressure on them to change their payment base to July 15.

In the case of my own State, that would inflict a penalty similar to the one inflicted on the Federal if you moved over a year in the fall. Therefore, would it not be a better idea to leave the dates as they now exist. Otherwise, the result is to have either two different payments for taxpayers or to cause the States at least an apparent fiscal deficit in the years in question, or at least in the first year?

Mr. AIDINOFF. I certainly think, Congressman Frenzel, that it is important that States and Federal harmonize to the extent possible. There certainly are a number of States I believe, who do not have a June 30 fiscal date. I think the problem with June 15 is basically—there are really two problems with June 15.

One, in terms of overall burden to taxpayers filing estimated taxes—considering that the first payment has been made April 15, to make another substantial payment on June 15 is very, very burdensome. In many cases, there are taxpayers who cannot file their tax returns until June 15. Right now they have automatic extensions even past that date.

Many taxpayers are unable really to take advantage of last year's tax as an alternative means of estimating their payments because they don't know what their last year's tax liability is even by June 15. And I think July 15 would considerably ease the burden in those cases.

I have to agree with you that with respect to those States that are on a June 30 fiscal, moving the June 15 date to July 15 and having the States harmonize will have a one-time budget problem.

Mr. **Frenzel**. My problem is that if the Federal goes to July 15, the States who do have the one-time budget problem probably will not choose to go themselves. I think that will put your taxpayer in a worse position—a better position perhaps from a cash flow standpoint, but probably worse from trying to remember when to make his payments.

I am going to try to remove that particular feature from the bill for that reason.

I have another question. I was surprised that the bill wouldn't include a provision for employers to round out to the nearest dollar the withholding. It always seems to me we round everything else. Everybody likes that, it saves a lot of money. Here we have a great chance to do that. I suppose it would be a particularly good thing for smaller employers.

Has the Tax Section of the bar ever considered that simplification suggestion?

Mr. **Aidinoff**. I am afraid, Congressman, that the Tax Section contains so many technically minded lawyers that that type of simplification never occurs to them. However, I am sure that we would have no opposition to that type of measure. We just don't think simply enough.

Mr. **Frenzel**. Thank you very much for a very direct answer and splendid testimony. I yield the balance of my time.

Chairman **Rostenkowski**. Are there any further questions?

If not, thank you very much.

The Chair calls Mr. Tillinghast, Mr. Coffino, Mr. Germain. Welcome gentlemen, to the committee. We would ask you to identify yourselves and proceed with your testimony.

STATEMENT OF DAVID R. TILLINGHAST, ESQ., HUGHES, HUBBARD & REED, NEW YORK, N.Y.

Mr. **Tillinghast**. Thank you, Mr. Chairman.

I am David Tillinghast, a member of the law firm of Hughes, Hubbard, and Reed in New York. I have a special interest in the provisions of title V of the bill that is under discussion today, because I am at the moment serving as the reporter on a project undertaken by the American Law Institute which involves the simplification and rationalization, if I may say so, of the foreign provisions of the code.

My purpose here is basically to say that I believe the provisions of title V are the kind of effort that it is not only appropriate but necessary for the Congress to continue to make in its efforts to simplify the tax law and make it more coherent.

I think it is little appreciated sometimes how much cost there is in the complexity, overlap and sometimes incoherence of some of these provisions.

I want to mention just three things briefly. First, I think that the provisions of section 501, which would provide a definition of the residence of an alien are a major step forward in an area that needs such a thing. I am sure that I, like others, if I were to write the provision myself, might write it differently. But I think the approach of the provision in trying to set relatively objective standards for the purpose of making this important tax determination is correct.

I would also support the approach to the problem of stapled entities. As Mr. Aidinoff said, I think many of us in the practicing bar would find it more acceptable if the remedy which was adopted for this problem were to consider the foreign stapled entity to be owned by the U.S. entity, rather than considering it itself to be a U.S. entity, which has certain ramifications which are quite wide.

On the other hand, it certainly is a problem that needs dealing with, and I think that a clear-cut solution which would provide the basis for clarity and certainty is much to be applauded.

I want to say particularly a few words about the provisions of sections 503 through 505 of the bill, which would apply to the foreign personal holding company and controlled foreign corporation provisions of the code. The five changes that are made in these sections are to my way of thinking all appropriate, all needed, and at least in two cases, long overdue.

But I do think that the committee and the Congress should keep in mind that this is in a sense tinkering. The area of the law that these changes are addressed to is one of really unparallelled incoherence, complexity, and difficulty to administer for the IRS, difficulty to comply with for the taxpayer.

There are not only the provisions on foreign personal holding companies and controlled foreign corporations, but indeed three other sets of provisions: Those relating to foreign investment companies, those relating to personal holding companies, which happen to be foreign corporations, and those relating to the accumulated earnings tax, all of which lie on top of each other, intersect in sometimes arbitrary, funny ways, producing immense complexity, producing immense difficulty for taxpayers to comply in a reasonable way.

I urge the committee not to step back from what it is doing now. I would not support withdrawing these provisions from this bill because I think they do make an improvement. But I would strongly urge that the committee keep on its agenda the possibility of doing a more complete revision and simplification of these provisions. I think that a great deal could be accomplished by so doing. I believe compliance in this area could be greatly enhanced and certainly costs and difficulties to taxpayers could be greatly reduced.

The American Law Institute project on which I am working is working in this area. We hope in due course to produce recommendations which, of course, we would be happy to share with you. I mean now only, however, to emphasize the importance of ongoing work in this area.

Thank you.

[Supplement to the oral statement follows:]

HUGHES, HUBBARD & REED, ONE WALL STREET,
New York, N.Y., July 28, 1983.

Re: Title V of H.R. 3475.

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing to supplement the statement I made in appearing before the Committee at the hearing on H.R. 3475 held on July 25, 1983.

First, I reaffirm that, while I do not personally agree with all of the details of all of the provisions of Title V, I believe that it represents a commendable and constructive attempt to address anomalies in the tax law which, although rather technical in nature, are important. Some of these affect a larger number of taxpayers, and presumably have larger revenue effects, than others. But in addressing all of them the Bill properly seeks to make the provisions of the statute relating to foreign income more coherent and equitable. To the extent that it accomplishes this, Title V will encourage increased understanding of and compliance with statutory provisions which are frequently complex and sometimes mystifying.

THE RESIDENCE RULE

Among the provisions of Title V, the one of most immediate importance is Section 501, embodying a new definition of the term resident alien (and, by exclusion, its opposite, non-resident alien). This distinction is of crucial importance in our tax system. An alien individual who is a resident of the United States is subject to federal income tax on all of his income, wherever derived. On the other hand, if the alien is not a resident, he or she is taxable only on specified categories of income derived in the United States. In practice, there are several additional respects in which the claim by an alien individual that he is a non-resident may defeat or make more difficult the task of taxing to him the income derived by entities which he owns or controls.

The existing law governing this distinction is hardly satisfactory. It consists of only a brief reference or two in the Treasury Regulations and a large and not always consistent body of case law and Internal Revenue Service rulings. To be a resident, a foreign person must be physically present in the United States. In addition, however, he must have an intention to stay; if he has an intention to leave within a definite time he may not be a resident. There are several presumptions and corollary rules which modify these basic rules. But the essential point is that the answer in each case depends upon a full examination of a broad range of factors which may point toward, or away from, a finding of residence. This case-by-case, all-factors-considered approach, built on the vague and subjective foundation of the individual's intention as to his stay in the United States, presents the Internal Revenue Service with a very difficult administrative burden—certainly a person's intent is not clear from his tax return. It also makes it difficult for practitioners to give clear advice with confidence. The result is that most individuals give themselves the generous benefit of any doubt. Although I am aware of no hard statistics on the subject, there is at least a suspicion among many informed observers that in the present state of the law, many aliens manage to live for relatively long periods of time in the United States while claiming that they are non-residents for tax purposes. One such case is documented in the Tax Court's decision in *Brittenham* v. *Commissioner,* 66 T.C. 373 (1966).

The purpose of section 501 is to replace the rather vague and subjective test of residence under existing law with a set of objective tests. This seems to be clearly the correct approach, since it should reduce administrative and compliance problems and IRS-taxpayer controversy in an area of importance to the tax system as a whole. I would wholeheartedly support this effort.

I am not so supportive of some of the particulars of this proposal. I believe that the committee should recognize that some of the tests set forth in section 501 are very tough, indeed, and would result in aliens being taxed as residents by the United States under circumstances in which most, if not all, other countries of the world would not assert a similar claim. It seems to me excessively harsh to consider an alien as a resident of the United States if he has merely applied for an immigrant visa (although it has not issued) and has been in the United States for 60 days in the year. To take an example, if a foreign businessman wished to apply to immigrate to the United States, he could not thereafter spend more than 60 days a year in the United States on business (or for any other reason) without paying U.S. tax on his worldwide income—and this even if in fact the application were never granted or were granted only 5 years later. The "physical presence" test of section 501(b)(1) also seems to me to go too far, to the extent it can result in a person's being considered a resident during a taxable year even though he was present in the United States at no time during the year.

One rough measure of reasonableness in matters of this kind is to put the shoe on the other foot. There are several provisions in the tax law under which an American is favored if he is a resident of a foreign country. The provisions of the Bill would not apply in this turned-around situation, and I dare say we might not wish to consider an American to be resident abroad in every case where he had applied for admission as a resident, even though he was still living in, say, Chicago.

In my judgment section 501 of the Bill goes too far. I would by no means abandon the thrust of the section; I believe that the principle involved is correct. I would merely contract the outer reaches of its impact.

STAPLED STOCK

Section 506 of H.R. 3475 relates to so-called "stapled entities". Under section 506(a), a corporation whose stock is stapled to the stock of a U.S. corporation will itself be considered a U.S. corporation for tax purposes, even though it otherwise would be considered a foreign corporation. This will result in the "foreign" corporation's income being fully subject to U.S. tax. This is surely a Draconian measure. There are many respects in which the taxation of the income of a corporation in such circumstances would be more extensive than the taxation of its income if it were merely a subsidiary of a U.S. parent. In particular, the result will be to impose U.S. tax on the earnings of the foreign corporation which ultimately accrue to foreign shareholders.

Under subsection (b) of section 506, the Secretary of the Treasury is given authority to "prescribe such regulations as may be necessary to prevent avoidance or evasion of federal income tax through the use of stapled entities". Whatever the Congress is disposed to do on this subject, I regard that delegation of authority to the Treasury Department as objectionably broad. What constitutes "avoidance" of federal income tax to the Treasury Department may just as reasonably be regarded by a taxpayer as complying with the law as it is written. I do not believe that there are any neutral principles or mandates of natural law in this situation to suggest what the proper scope of the federal income tax is and therefore what reasonably should be held to constitute "avoidance". Particularly, in an area where the proper limits of U.S. taxing jurisdiction seem to me to be an especially sensitive subject, I believe that it is specifically the obligation of the Congress to decide the matter and not to leave broad and difficult questions open to resolution by regulation without legislative guidance.

The second sentence of Subsection (b) suggests that the regulations may provide "the extent to which" one of the stapled corporations may be regarded as owning the other. If the intent were to permit the Treasury Department by regulation to set rules under which a stapled foreign entity might be regarded as owned by the twin U.S. entity, *in lieu of being treated as a U.S. corporation,* I would find this a helpful softening of the general rule of Subsection (a) and one which falls within a legitimate range of legislative delegation.

THE FOREIGN PERSONAL HOLDING COMPANY AND CONTROLLED FOREIGN CORPORATION RULES

Section 503, 504, and 505 would make changes in the rules relating to foreign personal holding companies and controlled foreign corporations. These relate to an area of the tax law of unparalleled complexity and confusion. Indignant at the avoidance of U.S. tax on investment income by wealthy individuals through the use of "incorporated pocketbooks" abroad, the Congress in 1937 enacted the provisions which tax individual U.S. shareholders on their shares of the income of a foreign personal holding company, whether distributed or not. In 1962, the Congress enacted so-called Subpart F, relating to controlled foreign corporations. This legislation, designed to apply to subsidiaries of U.S. parent corporations, as well as foreign corporations owned by U.S. individuals, also results in the imposition of tax on U.S. shareholders with respect to their shares of the undistributed income to foreign corporations. Unfortunately, both of these sets of rules may apply at the same time to the same shareholder of the same foreign corporation. Moreover, there are at least three other sets of what might be termed "penalty tax" provisions which may apply in like circumstances.

As this capsule history suggests, this is an area of the tax law which has simply grown like Topsy. The interrelation, duplication and overlap of various provisions of the law have been dealt with inadequately and, in some cases, not at all. Even within each of the tax regimes to which I have referred, serious technical anomalies have been indentified which are in need of correction.

The five changes which would be made in sections 503, 504 and 505 of the Bill are designed to correct some of the more important problems which have arisen. They are even-handed, in the sense that some would prevent inequities to taxpayers, while others would close unintended loopholes. In my view, all of these changes are appropriate and, in at least two cases, long overdue.

I cannot resist the temptation, however, to note that the amendments made by the Bill, appropriate as they are, merely scratch the surface of a much deeper and more important problem—the undue complexity, overlap and incoherence of the various provisions relating to foreign corporations to which I referred above. The Congress has made significant strides in recent years in enacting legislation which simplifies the Internal Revenue Code and makes its workings more understandable and coherent. This is important; it promotes compliance by reviving a sense of fairness in the tax law. I believe that the recent revisions of the tax treatment of Subchapter S corporations and of installment sales transactions are good examples of this process. I suggest that the foreign area is another one in which an effort of this kind is sorely needed. At the present time, I am serving as the Reporter for an American Law Institute study relating to the international aspects of federal income relating to the international aspects of federal income taxation. In this project we are in the process of preparing recommendations along these lines. While these proposals are not yet completed, they will be before long, and I commend them to your attention.

Very truly yours,

David R. Tillinghast.

Chairman Rostenkowski. Thank you, Mr. Tillinghast.

Mr. Coffino, you may proceed.

STATEMENT OF SOL COFFINO, PRESIDENT, TAX EXECUTIVES INSTITUTE, INC., AND VICE PRESIDENT, TAXES AND INTERNAL AUDIT, CASTLE & COOKE, INC.

Mr. Coffino. Thank you, Mr. Chairman.

Mr. Chairman and members of the Committee on Ways and Means, my name is Sol Coffino. I am vice president, taxes and internal audit for Castle & Cooke, Inc. in San Francisco, and president of Tax Executives Institute, Inc. [TEI]. I am appearing here today on behalf of TEI.

As the principal association of corporate tax executives and managers, TEI applauds the efforts of the sponsors of H.R. 3475 to identify major problem areas in the tax law and to propose solutions to those problems. The 3,800 individual members of TEI represent more than 1,100 of the leading corporations in the United States and Canada.

As such, we truly represent a cross section of the business community. We are dedicated to promoting the uniform and equitable enforcement of the tax laws and to reducing the costs and burdens of tax administration and compliance to the benefit of both Government and taxpayers.

Having stated the above preamble, we deeply appreciate the opportunity to comment on title VIII of H.R. 3475, the provision dealing with the "Simplification of Income Tax Credits." More specifically, we would like to focus on the foreign tax credit, a provision which truly affects large numbers of business taxpayers. In complying with the wishes of Chairman Rostenkowski, we believe our comments are indeed germane and related to the stated objectives of H.R. 3475 to simplify and improve the tax law.

We concur in the notion that business tax credits should be combined into one credit. We concur that such credits should be used on a FIFO basis, with a 3-year carryback and a 15-year carryforward. However, we strongly believe that the foreign tax credit should be included in the category of business tax credits. Clearly there is a compelling and logical need to add the foreign tax credit to the category of business tax credit whose interrelationships are to be rationalized under the bill.

The principal purpose of the foreign tax credit provisions of the Internal Revenue Code is the avoidance of double taxation on income earned by U.S. persons. The current rules, however, produce some significant inequities and frequently fail to accomplish their intended result.

For instance, under section 904(c) of the code, any credit not used against U.S. tax in the current year may be carried back only 2 years and forward only 5. If not utilized during these periods, the credit is lost. In our view, the carryback/carryforward rules are unreasonably restrictive and result in double taxation. Indeed, the rules are out of step with the other carryback and carryover provisions dealing with investment tax credits, targeted jobs credits and research activity credits.

TEI similarly believes that the current rules (that is, IRC section 904(f)) relating to the foreign tax credit "limitation" should be repealed or revised. The limitation is a mechanism that essentially limits the foreign tax credit to an amount not exceeding what the U.S. tax would be on the taxpayer's foreign-source income. Because of the asymmetrical treatment of foreign-source losses and domestic losses, however, the limitation frequently defeats the very purpose of the foreign tax credit: the avoidance of double taxation.

Finally, we believe the ordering rules for the use of foreign tax credit should be modified to conform with those of net operating losses and other credits, one of the stated purposes of H.R. 3475.

The current rules have a debilitating effect on business. In many cases, repatriation of millions of U.S. dollars is delayed because of foreign tax credit constraints. Moreover, companies with excess foreign tax credits or with permanent overall foreign losses under IRC section 904(f) cannot economically expand their overseas sales. Such companies are faced with prospective combined U.S. and foreign effective tax rates approaching 90 percent and are thereby precluded from doing business in foreign markets. Foreign controlled companies clearly have a competitive advantage.

On May 25, 1983, Representatives Gibbons, Conable, Duncan, and Jenkins introduced H.R. 3140, which would effect significant reforms in the existing foreign tax credit rules. As president of Tax Executives Institute, Inc., I urge you to amend title VIII of the Tax Law Simplification and Improvement Act of 1983 to incorporate the provisions of H.R. 3140, the Foreign Tax Credit Conformity Act of 1983.

TEI strongly believes that incorporating the provisions of H.R. 3140 into the Tax Law Simplification and Improvement Act of 1983 will further its stated purpose to simplify and improve the Internal Revenue Code.

We have submitted a detailed analysis of these provisions, and we would be ready to respond to any questions or submit any further information requested by the committee.

[The analysis follows:]

January 13, 1983

TAX EXECUTIVES INSTITUTE, INC.

APPENDIX A

NEED FOR FOREIGN TAX CREDIT CONFORMITY

Background

The United States was the first country to provide a credit on a worldwide basis against the federal income tax for the amount of income taxes paid foreign countries or U.S. possessions.[1] The purpose of the credit is simple: to prevent the double taxation of income earned by U.S. persons. U.S. persons are subject to federal income tax on their worldwide income whether it is earned in the U.S. or elsewhere.[2] In addition, practically all foreign countries also tax all income that is in some way effectively connected with their jurisdiction. Consequently, in the case of a U.S. person doing business overseas directly or through a foreign subsidiary, the resulting income will almost always be taxed twice. The foreign tax credit is designed to prevent this inequity.

The existing foreign tax credit rules, however, carry with them some rather significant inequities. For instance, under section 904(c), any credits not used against U.S. tax in the current year may be carried back only two years and forward only five. These rules are unreasonably restrictive and out-of-step with other provisions in the Internal Revenue Code. Moreover, through the vehicle of the foreign tax credit "limitation," the amount of the foreign tax credit cannot exceed what the U.S. tax would be on the taxpayer's foreign source income.[3] The existing rules for determining the amount of the "limitation" frequently result in double taxation -- thus defeating the very purpose of the foreign tax credit -- and should either be repealed outright or substantially modified. The following briefly reviews these issues and suggests appropriate remedial legislation.

---

[1] See generally E. Owens, The Foreign Tax Credit: A Study of the Credit for Foreign Taxes under United States Income Tax Law (1960). The foreign tax credit was originally enacted as part of the Revenue Act of 1918; the current provisions (I.R.C. §§ 901-08) were in large part contained in the Internal Revenue Code of 1954 as originally enacted.

[2] I.R.C. § 61(a).

Foreign Tax Credit Carryback/Carryover Rules

The foreign tax credit carryback/carryover provisions (two years back and five years forward) pale in comparison to the analogous rules in respect of the investment tax credit (section 46(b)) and net operating losses (section 172(b)); those rules provide for a three-year carryback and a fifteen-year carryforward. There is no readily explainable reason for the harsher rules in the foreign tax credit area. In fact, when each was originally enacted as part of the 1954 Code, the carryforward/carryback provisions in respect of net operating losses and the foreign tax credit were identical -- two years back and five years forward.[4] Although the rules have been liberalized several times for net operating losses (and investment tax credits) since 1954, the foreign tax credit provisions have, for no apparent reason, been substantially

---

3. I.R.C. § 904(a).

4. I.R.C. §§ 172(b)(1) and 904(c), as originally enacted.

ignored.[5]

In addition, the ordering rules for foreign tax credits require that the current year's credits be utilized before any carryovers.[6] By contrast, in respect of the investment tax credit, a carryover is to be used first, before the current year's credits, to afford the taxpayer the maximum opportunity of using the credit.[7]

This lack of consistency and equity in the Code penalizes taxpayers who experience operating losses such that the government often reaps a windfall at the expense of distressed taxpayers. Consider, for example, a situation where a company is projecting net operating losses for both 1982 and 1983. These losses will be carried back to 1979 and 1980, respectively, possibly reducing taxable income in each of those years to zero. Because of the loss carrybacks to 1979 and 1980, the foreign tax credit attributable to taxes paid in those two years may be carried back two years and forward five. If there is no foreign tax credit limitation available in years prior to 1979, the only alternative is to carry the credits forward to 1984. This means that 1984 will be the only year available to absorb the 1979 credits and then only if there is still limitation some part of the limitation available after absorbing any 1984 credits. Thus, in this example the 1979 credit carryover, triggered by a 1982 loss, must be absorbed in 1984 or double taxation of the 1979 foreign income will result.

---

[5] The Small Business Tax Revision Act of 1958 (Pub. L. No. 85-866) lengthened the NOL carryback period to three years and the NOL carryforward period to five years. The Tax Reform Act of 1976 extended the carryforward period to seven years. The Economic Recovery Act of 1981 increased the length of the NOL carryforward period to 15 years.

As originally enacted as part of the Revenue Act of 1982, investment credits could be carried back three years and carried forward five years. Pub. L. No. 89-800 (Nov. 6, 1966) extended the investment credit carryforward period to seven years. ERTA lengthened the carryforward period to 15 years.

[6] I.R.C. § 904(c).

[7] I.R.C. § 46(a)(1).

What often occurs under current rules, then, is that the government collects a substantial portion (if not all) of foreign tax credits previously earned and claimed because of the short carryback/carryforward period. Indeed, the lack of consistency in the foreign tax credit area effectively undermines the intent behind both the foreign tax credit and the NOL carryback/carryforward rules, for the net operating loss relief is reduced by the previously allowed foreign tax credits. The current foreign tax credit rules, therefore, place an even larger burden on a distressed company trying to recover from a loss position.

The present carryback/carryover rules can also adversely affect the cash flow from foreign subsidiaries. Specifically, a company's inability to utilize the foreign tax credits associated with dividends that would otherwise have been repatriated from foreign subsidiaries, in combination with the doubtful outlook for ultimate realization of the credits within the carryback/carryover period, might well lead the company to cancel dividends planned from these companies; it simply could not risk having the carryover period expire before the credit could be utilized. Such a result is especially troublesome where the company has short-term borrowings outstanding against which the cash dividends could be applied. In such a case, the cash generated by foreign subsidiaries would remain in foreign bank accounts to the benefit of the credit markets outside of the United States while the company was compelled to borrow additional funds in this country.

In addition, the failure to repatriate earnings from foreign subsidiaries impairs our country's balance of payments and encourages expansion overseas rather than in the United States. Thus, the present rules seem ill advised not only as a matter of tax planning but also from an economic policy standpoint.

Tax Executives Institute recommends that corrective action be taken to end these inconsistent and inequitable results. Specifically, section 904 of the Internal Revnue Code should be amended to provide a foreign tax credit carryback/carryover period that is identical with that allowed for net operating losses and investment tax credits (i.e., three years back and fifteen years forward). Second, the ordering rules for foreign tax credit purposes should parallel those for the investment credit: any carryover credit should be taken into account before the current year's credit. Finally, section 6411 should be amended to permit taxpayers to file an application for a tentative carryback adjustment in respect of a foreign tax credit carryback; there is absolutely no reason the "quickie" refund rules of the Code (which, of course, already apply in respect of investment credit and loss carrybacks) should not apply in respect of foreign tax credits.

Foreign Loss Recapture Rules -- Section 904(f)

The recapture rules of section 904(f) are deficient in several respects. Perhaps most significant, they lack symmetry in situations where foreign source income is offset by a domestic source loss. This could result in an unintended permanent loss of foreign tax credits with respect to the foreign taxes paid on the foreign source income, unless in subsequent years an equal amount of domestic source income is reclassified as foreign source income. The unfairness and illogic of such a result is best illustrated by the examples attached as Schedules A (and elaborated on in Schedule B). Example 1 in Schedule A illustrates the effect of section 904(f) in requiring the recharacterization of foreign income as domestic income to the extent of the prior overall foreign loss. Section 904(f), of course, provides for recapture of overall foreign losses and does not provide for similar recapture treatment when there is an overall domestic loss which is offset against foreign income in year one and in a subsequent year or years there is sufficient domestic income to otherwise absorb such overall domestic loss. Consequently, the credit can be lost where a taxpayer has an overall domestic loss and positive foreign income.

This unjustified result is illustrated by Example II in Schedule A. In year one the domestic loss offsets the foreign income and there is no net U.S. income tax liability. The excess foreign tax credit of $46,000 in year one is available as a carryback or carryforward under section 904(c). In year two foreign income is at the same level as in year one ($100,000) and foreign tax paid or accrued totals $46,000. Domestic income is $100,000 and the total U.S. taxable income equals $200,000. This results in a U.S. income tax liability of $92,000. With no recapture provisions for the prior year's overall domestic loss the section 904 limitation is equal to the ratio of foreign source income ($100,000) to total U.S. taxable income in year two ($200,000) multiplied by U.S. income tax before credit ($92,000), or $46,000. As a result, the taxpayer's net U.S. income tax liability in year two is $46,000. Since there is no net domestic income for the two-year period (therefore, no net U.S. tax should have been incurred), the pre-credit U.S. income tax ($92,000) for the two-year total foreign income ($200,000) should have been totally offset by $92,000 of foreign tax credit.

Thus, section 904(f) often operates to cause the very thing the foreign tax credit was intended to prevent -- double taxation. This, in turn, discourages companies from making investments that could benefit the U.S. economy as a whole. Tax Executives Institute believes that the inequities caused by the foreign tax credit limitation can best be eliminated by repealing section 904(f) outright. At a minimum, however, the harsh effects of the provision should be ameliorated by making several modifications in section 904(f). First, the overall loss provisions should be extended to apply equally to domestic loss situations to the extent the overall domestic loss offsets foreign source income in any year. In other words, the domestic loss recapture rule should become the mirror image of the foreign loss recapture rule. The effect of such a change is illustrated by Example III in Schedule A. In year two to the extent that the overall domestic loss from year one would otherwise have been absorbed against domestic income, such recapture of domestic loss should be reclassified as foreign source income consistent with the similar treatment afforded the recapture of foreign losses under section 904(f).

There is, moreover, a conflict between section 904(f) and section 1.861-8(e)(8) of the regulations that will lead to a double loss of foreign tax credits in situations where a taxpayer has a foreign source loss and an overall net operating loss. In such a case, when the net operating loss is carried back, the foreign portion of that loss will offset the foreign source income in the carryback year resulting in loss of tax credits in the carryback year. At the same time, section 904(f) requires that the overall foreign loss that was carried back under section 1.861-8 be recaptured against future foreign source income, again resulting in losses of foreign tax credits. This is hardly consistent with the policy of the foreign tax credit to avoid double taxation. To effectuate the purposes underlying the foreign tax credit provisions of the Code, section 904(f) should be modified so that the amount to be recaptured is reduced by the amount offset against foreign source income in the carryback year.

Under section 904(f)(1), the amount of overall foreign losses must be recaptured by reclassifying subsequent years foreign source income as domestic source income. This reclassification effectively denies taxpayers the intended benefit of foreign tax credits. Under current law, the amount of income subject to reclassification in any one year is limited to 50 percent of the foreign source income for that year before reclassification.[8] This rule makes it extraordinarily difficult for a taxpayer in an overall foreign source loss position to use its foreign tax credits since current year's foreign source income is always first recaptured under section 904(f) thereby reducing the amount of limitation available for current years. If the overall foreign loss subject to recapture is sufficiently large (because, for example, of a foreign worthless stock or bad debt deduction), the taxpayer might be unable to utilize foreign tax credit for a number of future years.

Tax Executives Institute believes the time frame for recapturing overall foreign losses is over restrictive. We accordingly propose that overall foreign losses be treated in the same manner as domestic net operating losses, that is, over a fifteen-year period. In addition, to eliminate the harsh effects on the ability to absorb foreign tax credits in the year immediately subsequent to the overall loss year, we propose that the amount of foreign source income to be recaptured in any one year be changed from the present 50 percent of foreign source income before reclassification to 6-2/3 percent. The latter percentage corresponds to a pro rata recapture over the fifteen-year period. As in the current law, the taxpayer should also have a choice of recapturing more than the required amount in any given year.

---

[8] I.R.C. § 904(f)(1)(B).

Schedule A

	Example I §904(F) - Foreign Loss Recapture		Example II Present Law-Domestic Loss		Example III Proposal-Domestic Loss Recapture	
		Foreign Tax		Foreign Tax		Foreign Tax
YEAR 1						
Foreign Source Income	$(100,000)	$ -0-	$ 100,000	$46,000	$ 100,000	$46,000
Domestic Source Income	100,000		(100,000)		(100,000)	
U.S. Taxable Income	$ -0-		$ -0-		$ -0-	
U.S. Income Tax	$ -0-		$ -0-		$ -0-	
Allowable Foreign Tax Credit (Schedule B)	$ -0-	-0-	$ -0-	-0-	$ -0-	-0-
Excess Foreign Tax Credit (Year 1)		$ -0-		$46,000		$46,000
YEAR 2						
Foreign Source Income	$ 100,000	$46,000	$ 100,000	$46,000	$ 100,000	$46,000
Domestic Source Income	100,000		100,000		100,000	
U.S. Taxable Income	$ 200,000		$ 200,000		$ 200,000	
U.S. Income Tax	$ 92,000		$ 92,000		$ 92,000	
Allowable Foreign Tax Credit (Schedule B)	$ -0-	-0-	$ 46,000	46,000	$ 92,000	92,000
Excess Foreign Tax Credit (Limitation) (Year 2)		$46,000		$ -0-		$(46,000)
SUMMARY						
Foreign Source Income						
Year 1	$(100,000)		$ 100,000		$ 100,000	
Year 2	100,000		100,000		100,000	
	$ -0-		$ 200,000		$ 200,000	
U.S. Income Tax	$ 92,000		$ 92,000		$ 92,000	
Foreign Tax Credit	-0-		46,000		92,000	
Net U.S. Income Tax	$ 92,000		$ 46,000		$ -0-	
Excess Creditable Foreign Tax	$ -0-		$ 46,000		$ -0-	

SCHEDULE B
FOREIGN TAX CREDIT LIMITATION

	I	II	III
YEAR 1	$\frac{-0-}{-0-} \times -0- = \underline{\underline{-0-}}$	$\frac{100{,}000}{-0-} \times -0- = \underline{\underline{-0-}}$	$\frac{100{,}000}{-0-} \times -0- = \underline{\underline{-0-}}$
YEAR 2	$\frac{100{,}000 - 100{,}000}{200{,}000} \times 92{,}000 = \underline{\underline{-0-}}$	$\frac{100{,}000}{200{,}000} \times 92{,}000 = \underline{\underline{46{,}000}}$	$\frac{100{,}000 + 100{,}000}{200{,}000} \times 92{,}000 = \underline{92{,}000}$

Mr. PEASE [presiding]. Thank you very much.

Mr. Germain.

STATEMENT OF ALBERT E. GERMAIN, VICE PRESIDENT, TAXES, ALUMINUM CO. OF AMERICA, ACCOMPANIED BY ERNEST S. CHRISTIAN, JR., COUNSEL

Mr. GERMAIN. Thank you.

I am Albert E. Germain, vice president of taxes for Aluminum Co. of America. I am accompanied by Mr. Ernest Christian, Jr. It is a pleasure for us to appear before this committee.

We commend the committee and its staff for the initiatives taken in H.R. 3475 toward simplifying and synchronizing various complex and related provisions of the tax law. Over the years, many intricate amendments have been added to the code for different purposes at different times. It is appropriate occasionally to step back and see if they operate in a parallel and consistent manner with one another.

H.R. 3475 has appropriately undertaken to provide parallel carryover and ordering rules for business tax credits such as the investment tax credit, the jobs credit, the alcohol fuels credit, the research credit, and the ESOP credit, which step toward consistency and uniformity we support. All those credits would now be conformed to the modern investment tax credit: a 15-year carryover and a FIFO ordering rule.

H.R. 3475 does not, however, go far enough. H.R. 3475 should also addresss the foreign tax credit in the same context of consistency and uniformity. There is an element of inconsistency in the foreign tax credit, both as to the carryover and ordering rules of the credit and as to the underlying calculation of the amount of credit that may be carried over.

In determining whether an amount of foreign tax is currently creditable instead of having to be carried over, present law is not parallel and consistent in the way it takes losses into account in calculating the foreign tax credit limitation, which is based on the ratio of net foreign source income to net worldwide income. In general, under that limitation, the higher the ratio of foreign source income to domestic source income, the higher will be the amount allowed as a credit for the foreign taxes actually paid.

The 1976 act added section 904(f) to recapture a prior year foreign source loss against later year foreign source income, which would thereby be recharacterized into domestic source income, solely for purposes of the limitation calculation. Section 904(f) was enacted to prevent a taxpayer from deriving a double tax benefit from a foreign source loss, that is, double counting. The 1976 act was, however, incomplete in that it did not provide a parallel rule for the recapture of domestic losses in order to prevent a double tax burden.

It is necessary to recapture a domestic source loss in order to prevent an unintended and inequitable double tax burden. This double burden occurs when foreign income is eliminated by a domestic loss which prevents credibility of taxes actually paid on such income. Failure to recapture domestic source losses in a manner consistent with recapture of foreign losses produces a significant degree of double taxation of foreign source income which occurs not for any conceivable policy reason we have ever heard suggested, but solely as a result of the nonparallel structure of section 904(f).

Present law may also produce a substantial double counting of losses that may affect more than 1 year within various carryback and carryover periods. The same dollar of loss may both reduce foreign source income in a year to which it is carried back under the NOL provisions and reduce foreign source income again in a later year in which it is recaptured under the provisions in section 904(f). There is no conceivable policy reason for this possible double counting which arises solely from the failure of section 904(f) to mesh properly with certain case law and the source rules under section 861.

H.R. 3475 should contain a corrective amendment which would provide a parallel rule for recapture of all losses without regard to source, but only to the extent a loss from one source had offset income from the other source; that is, foreign source losses would be recaptured to the extent they offset domestic source income and vice versa. Concomitant technical changes would be made with respect to taking NOL's into account.

Further, H.R. 3475 should be expanded to make the carryover and ordering rules for the foreign tax credit parallel with the investment tax credit where the carryover period is 15 years and a FIFO rule is applied so that the oldest credits are used first. H.R. 3475 already proposes that be done with the four business tax credits mentioned earlier. There is no reason why the foreign tax credit should be omitted and left to remain under the 1958 vintage 5-year carryover subject to a rule requiring the current year's credits to be used before credits carried over from a prior taxable year.

Originally, both the investment tax credit and the foreign tax credit had a 5-year carryover and the archaic LIFO-type ordering rule. The investment tax credit has been modernized and so should the foreign tax credit. The present 15-year carryover period for the investment tax credit and the FIFO ordering rule are the result of a series of amendments, primarily in 1976 and 1981, which reflected the growing recognition by this committee and various tax policy analysts that the older, unduly restrictive carryover and ordering rules produced random and arbitrary distortions.

I thank the committee for its attention. I request that a technical appendix to be submitted, be included in the record.

Mr. PEASE. Thank you very much, Mr. Germain. Without objection it will be included in the record.

[The appendix follows:]

APPENDIX

TO

STATEMEMT OF ALBERT E. GERMAIN
VICE PRESIDENT-TAXES
ALUMINUM COMPANY OF AMERICA

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

July 25, 1983

Re: H.R. 3475 -- Tax Law Simplification And Improvement Act Of 1983

I. Proposed Amendment To Section 904(f) To Recapture An Overall Domestic Loss -- Title V

A. Summary Of Amendment

An "overall domestic loss" would be defined as the excess of the deductions apportioned or allocated to domestic income, including the section 172(a) net operating loss deduction, over domestic gross income only to the extent that foreign source income is actually offset by an overall domestic loss. This overall domestic loss would be recaptureable and thus reclassified as foreign source income in subsequent years when the taxpayer has domestic source income. The taxpayer would reclassify as foreign source income the lesser of (i) the amount of the overall domestic loss (reduced by recapture of overall domestic losses in prior years), or (ii) 50 percent (or more, as the taxpayer chooses) of the domestic income in such year.

B. Interaction of Present Section 904(f) as Applied to Foreign Source Loss With Proposed Amendment to Section 904(f) as Applied to Domestic Source Loss

The same U.S. taxpayer may have both an overall foreign loss subject to recapture and a domestic source loss subject to recapture. Recaptures of these two types of losses may interact with one another as illustrated by simple Examples (1)(A) and (1)(B), neither of which involve NOL's or any of the other interpretative questions that exist under present law with respect to the recapture of an overall foreign loss.

EXAMPLE (1)(A)

Assume that the proposed amendment to recapture an overall domestic loss has been enacted and assume the following facts:

Taxable Year	Domestic Source Taxable Income	Foreign Source Taxable Income	Worldwide Taxable Income
1	$50	($50)	0
2	($50)	$51	$1

In Example (1)(A), the $50 overall foreign loss from year 1 is recaptured in year 2. As a result, $50 of year 2 foreign source taxable income is recharacterized into $50 of domestic source taxable income which offsets the $50 domestic source loss in year 2. Thus, there is no overall domestic loss in year 2 and no amount to be recaptured in the future under the proposed domestic source loss recapture rule.

EXAMPLE (1)(B)

Taxable Year	Domestic Source Taxable Income	Foreign Source Taxable Income	Worldwide Taxable Income
1	($50)	$50	0
2	$51	($50)	$1

In Example (1)(B), the $50 domestic source loss in year 1 offsets $50 of foreign source taxable income, thus giving rise to a $50 overall domestic loss that may be recaptured in a later year. In year 2, the $50 overall domestic loss from year 2 is recaptured. As a result, $50 of domestic source taxable income in year 2 is recharacterized into $50 of foreign source taxable income which offsets the $50 of foreign source loss in year 2. Thus, there is no overall foreign loss in year 2.

Additional examples of more intricate interactions between the recapture of an overall domestic loss and the recapture of an overall foreign loss require certain assumptions about how present section 904(f) is properly to be applied to foreign source losses. Under present law, an overall foreign loss might arise even though that foreign source loss has not offset domestic source taxable income. Therefore, despite the legislative history to the contrary, there is the possibility of "double counting" through the combined application of Motors Ins. Corp. and Reg. § 1.861-8(e)(8), *i.e.*, to the extent that a dollar of overall foreign loss is reflected in an NOL, that dollar may *both* wipe out a dollar of foreign source taxable income in a year to which the NOL is *carried* and through recapture under section 904(f) wipe out an additional dollar of foreign source taxable income in some future year. A further question under present law is whether an overall foreign loss will be recaptured against foreign source taxable income in a year in which there is a domestic source loss which equals or exceeds the foreign source taxable income for that year. These problems with present section 904(f) are not created or exacerbated by the proposed amendment to recapture an overall domestic loss. They need to be cured whether or not the proposed amendment is enacted.

Based on alternative assumptions about how present section 904(f) is to be applied, Examples (2), (3), and (4) illustrate a wide range of interactions between the proposed amendment to recapture an overall domestic loss and the recapture of an overall foreign loss (including *Motors Ins. Corp.* and Reg. § 1.861-8(e)(8)).

Examples (2) and (3) illustrate that precisely the correct result is produced by the interaction of the two recapture rules if it is assumed that the above-stated problems with present law are cured. After the 9-year period in Examples (2) and (3) in which there are overall domestic losses, overall foreign losses, and NOL carryovers and carrybacks, the foreign source income numerator of the section 904 limitation is exactly equal to the amount of foreign source taxable income. Thus, the underlying policies of both present section 904(f) as related to overall foreign losses and the proposed amendment to section 904(f) as related to overall domestic losses, are fully achieved. Indeed, the proposed amendment to recapture an overall domestic loss is necessary in order to achieve that result.

Examples (2) and (3) are identical in every respect except that Example (2) assumes that the "double counting" problem under present law is cured by a statutory amendment which provides that an overall foreign loss will be recaptured only to the extent it offsets domestic source taxable income and, concomitantly, that NOL's will be taken into account in determining the year and amount of an overall foreign loss.[1/] Instead of a statutory amendment, Example (3) assumes that the Treasury will issue regulations providing that an overall foreign loss for a year shall

---

1/ Such a statutory solution would be most consistent with the original concept of foreign loss recapture, as well as with the legislative history of section 904(f) itself. Such a straightforward statutory amendment would be a preferable solution. On the other hand, as illustrated in Example (3), it is possible for the Treasury to solve the problem by the issuance of regulations which properly reconcile the interaction between section 904(f) and Reg. § 1.861-8(e)(8).

be reduced to the extent it gives rise to an NOL in the year and under Motors Ins. Corp. and Reg. § 1.861-8(e)(8) that NOL is treated as having reduced foreign source taxable income in a prior or future year. Examples (2) and (3) also assume that under Treasury regulations both overall foreign losses and overall domestic losses are recaptured against foreign source taxable income and domestic source taxable income, respectively, irrespective of whether there is worldwide taxable income in the year of recapture.

Example (4) illustrates the interaction of the two recapture rules on the assumption that the above-stated problems with present law are not cured by either statutory amendment or Treasury regulations. In Example (4), there is "double counting" as a result of Motors Ins. Corp. and Reg. § 1.861-8(e)(8). Also, losses are not recaptured in a year in which there is no worldwide taxable income. The foreign source income numerator of the section 904 limitation is less than the amount of foreign source taxable income. Morever, an additional $20 of overall foreign loss remains to be recaptured after year 9 which will further increase the disparity in the future. This defect in result, compared to Examples (2) and (3), is not a fault in the proposed amendment to recapture an overall domestic loss. Rather, the disparity reflects the aberrational results of present law under the "worst case" assumption in Example (4).

EXAMPLE 2

'axable Year	Domestic Source Taxable Income	Foreign Source Taxable Income	Worldwide Taxable Income	*/ NOL Deduction §172(a)	Taxable Income	Foreign Source Income (Numerator)	Overall Domestic Loss	Overall Foreign Loss	*/ Domestic Loss Recapture	*/ Foreign Loss Recapture
1	30	20	50	(50) [2]	0	0	-	30		
2	0	(50)	(50)		0	0	-	-		
3	(50)	20	(30)		0	0	-	-		20 [1]
4	(30)	90	60	(30) [3]	30	30	50			10 [1]
5	50	50	100		100	100			50 [4]	
6	100	20	120	(120) [9]	0	0				
7	50	(20)	30		30	0		20		
8	70	60	130		130	40				20 [7]
9	(100)	(20)	(120)		0	0				
		170				170				

* Bracketed [ ] numbers indicate year-of-origin of NOL deduction § 172(a), of domestic loss, or foreign loss whichever is applicable.

Assumptions: (a) proposed overall domestic loss recapture rule is enacted; (b) section 904(f) is amended to take NOL's into account and to require recapture of an overall foreign source loss only to the extent that loss has offset domestic source taxable income; and (c) an overall loss, foreign or domestic, is recaptured to the extent of foreign source taxable income or domestic source taxable income, respectively, whether or not there is in the year any worldwide net taxable income.

EXAMPLE 3

Taxable Year	Domestic Source Taxable Income	Foreign Source Taxable Income	Worldwide Taxable Income	*/ NOL Deduction §172(a)	Taxable Income	Foreign Source Income (Numerator)	Overall Domestic Loss	Overall Foreign Loss	*/ Domestic Loss Recapture	*/ Foreign Loss Recapture
1	30	20	50	(50) [2]	0	0	-			
2	0	(50)	(50)		0	0	-	50 (20) **		
3	(50)	20	(30)		0	0	-			20 [2]
4	(30)	90	60	(30) [3]	30	30	50			10 [2]
5	50	50	100		100	100			50 [4]	
6	100	20	120	(120) [9]	0	0				
7	50	(20)	30		30	0		20		
8	70	60	130		130	40				20 [7]
9	(100)	(20)	(120)		0	0		20 (20)***		
		170				170				

* Bracketed [ ] numbers indicate year-or-origin of NOL deduction § 172(a), of domestic loss, or of foreign loss whichever is applicable.

** In year 2, there is an initial overall foreign loss of 50 of which 20 is offset against foreign source income of 20 in year 1, leaving a recaptureable overall foreign loss of 30 in year 2.

*** In year 9, the initial overall foreign loss of 20 is reduced to the extent it offsets foreign source income of 20 in year 6.

Assumtpion: (a) Proposed overall domestic loss recapture rule is enacted; (b) regulations are issued to provide that the recaptureable amount of an overall loss shall be reduced to the extent that the loss gives rise to an NOL for that year which reduces prior or future years' foreign source income pursuant to Reg. § 1.861-8(e)(8); and (c) an overall loss, foreign or domestic, is recaptured to the extent of foreign source taxable income or domestic source taxable income, respectively, whether or not there is in the year any net worldwide taxable income.

EXAMPLE 4

Taxable Year	Domestic Source Taxable Income	Foreign Source Taxable Income	Worldwide Taxable Income	*/ NOL Deduction §172 (a)	Taxable Income	Foreign Source Income (Numerator)	Overall Domestic Loss	Overall Foreign Loss	*/ Domestic Loss Recapture	*/ Foreign Loss Recapture
1	30	20	50	(50) [2]	0	0	-			
2	0	(50)	(50)		0	0	-	50		
3	(50)	20	(30)		0	0	20			
4	(30)	90	60	(30) [3]	30	30	10			50 [2]
5	50	50	100		100	80			20 [3] 10 [4]	
6	100	20	120	(120) [9]	0	0				
7	50	(20)	30		30	0		20		
8	70	60	130		130	40				20 [7]
9	(100)	(20)	(120)		0	0		20		
		170				150				

* Bracketed [ ] numbers indicate year-of-origin of NOL § 172(a) deduction, of domestic loss, or of foreign loss whichever is applicable.

Assumptions: (a) Proposed overall domestic loss recapture rule is enacted; (b) no other statutory or regulation change is made with respect to interaction of present section 904(f) and Reg. § 1.861-8(e)(8); and (c) recapture of an overall foreign or domestic loss does not occur in a year in which there is no net worldwide taxable income.

II. Proposed Amendment To Sections 904(a) And 904(c) To Provide A 15-Year Carryover And A FIFO Ordering Rule For The Foreign Tax Credit -- Title VIII

A. Summary Of Amendment

Both the carryover period for foreign tax credits and the order-in-time for utilization of such credits would be conformed to the investment tax credit. Thus, the carryover period for foreign tax credits would be 15 years (instead of 5 years under present law) and the ordering rule would be a FIFO system whereby the oldest credits are used first (instead of the current year's credits being used first as under present law).

B. Historical Perspective

Originally, in 1958 and 1962, respectively, the foreign tax credit and the investment tax credit had the same carryover period and the same ordering rule: the 5-year carryover and LIFO-type ordering rule that still applies to the foreign tax credit. Over the years, the investment credit has been modernized, commensurate with the growing recognition that restrictive carryover and ordering rules arbitrarily produce random inequities which are inconsistent with the underlying purposes of the credit and are inconsistent with related changes in the tax laws that have occurred in the meantime. Changes with respect to net operating losses in 1976 and 1981, and changes in allowable depreciation rates in 1971 and 1981 are good examples. All the while, however, unlike the investment tax credit and the other credits addressed in H.R. 3475, the foreign tax credit has remained unchanged.

The following Table I sets forth the chronology of changes in the investment tax credit, as compared to the foreign tax credit.

TABLE I

HISTORY OF INVESTMENT TAX CREDIT AND FOREIGN TAX CREDIT CARRYOVER AND CARRYBACK RULES

Year/Law		Foreign Tax Credit	Investment Tax Credit
1958	P.L. 85-866	Added 2-year carryback and 5-year carryover; current year's credits considered first, then FIFO.	
1962	P.L. 87-834		Added ITC with 3-year carryback; 5-year carryover; current year's credits considered first, then FIFO.
1966	P.L. 89-800		Extended carryover to 7 years.
1969	P.L. 91-172		Extended carryovers 3 additional years, but suspended the ITC and added limitations on the extent to which credit could be applied.
1971	P.L. 92-178		Permitted unused credits from credit years ending before 1971 to be carried over for 10 years; new credits eligible for a 7-year carryover; allowed pre-'71 carryovers to be used before current year's credits.
1976	P.L. 94-455 (Tax Reform Act Of 1976)	Section 904(c) rewritten to apply to all foreign source income and credits in the aggregate rather than on a per-country basis; same carryover and ordering rules.	Changed ordering rules to almost a pure FIFO system with carryovers to be used before current year's credits; includes special rule resulting from 10-year life of pre-1971 credits.
1981	P.L. 97-34 (Economic Recovery Tax Act)		Extended carryover to 15 years.

C. General Discussion

The foreign tax credit is intended to recognize the prior right of source countries to tax income earned therein and to prevent the double taxation of that income. Thus, the foreign tax credit is structured to reduce or to offset U.S. tax liability on that income by the amount of such foreign tax. A taxpayer may have foreign source income and pay foreign taxes in a year when it has insufficient U.S. tax liability to absorb the credit for foreign taxes paid. When a later year produces U.S. taxable income from foreign sources, the earlier year's unused credit should -- and perhaps can -- be taken into account as a credit carryover to such year. But, by placing such carryovers behind credits arising in the current year and by allowing only a 5-year carryover, present law creates the risk that such credits will be lost.

D. Hypothetical Example Of Disharmony Under Present Law

The following hypothetical example, which is not intended to represent the situation of any particular taxpayer, illustrates one type of inconsistent result that may occur under the present restrictive carryover and ordering rules applied to the foreign tax credit.

1. The taxpayer incurs very large net operating losses in both 1982 and 1983 while realizing foreign

source income that includes foreign taxes. Under present law, the NOL can be carried back 3 years and then carried forward up to 15 years, or at the taxpayer's option, can be only carried forward up to 15 years. Thus, the taxpayer's NOL from 1982 could be carried back to 1979, 1980 and 1981, and the 1983 NOL could be carried back to 1980 and 1981. (1982 is already a loss year.) But the very substantial 1982 NOL completely eliminates taxable income in both 1979 and 1980, thereby freeing up additional foreign tax credits to be carried back for 2 years and then forward 5 years. For example, $10,000 of freed credits from 1979 due to the NOL carryback could be carried back to 1977 and 1978 for possible use. But the ordering rule requires that credits arising in the taxable year must be used prior to carryovers from earlier years and to carrybacks. Therefore, unless the taxpayer has a sizable unused foreign tax credit limitation in 1977 and 1978, the credit carryback from 1979 is not likely to be of much value. As a carryforward, the freed credits from 1979 begin the 5-year carryover period already in serious jeopardy of being lost. The NOL carryback has also eliminated taxable income in 1980 and severly curtailed taxable income in 1981. This frees more credits from those years, and there is no unused limitation capability to absorb the carryover from 1979. Since 1982 and 1983 are already useless as carryover years by virtue of the losses generated in such years, the 1979 credit carryover must go into 1984 with only 1 year remaining in the 5-year carryover period. Again, assuming that taxable income exists in 1984, the taxpayer must have an unused limitation position to absorb the carryover.

2. The taxpayer in this example could elect to relinquish the 3-year NOL carryback in order to preserve the prior use of the 1979, 1980 and 1981 credits that have already been used. But the result of this election probably will merely be to delay the loss of some credits. The sizable NOL carryforward from 1982 and 1983 probably will eliminate tax liability in 1984, 1985 and beyond, depending upon the unknown level of taxable income in those years in comparison to the NOL carryforward. Thus, a foreign tax credit carryover resulting from the 1982 loss (assuming little or no benefit from the 2-year carryback period) is in its fourth year in 1986 and still must wait behind the current year credit. Thus, the foregone NOL carryback would be of questionable value.

3. The NOL situation in this example is worsened for taxpayers whose foreign tax rates are comparable to the 46 percent U.S. corporate rate. In such cases, the taxpayer perennially pushes against the limitation leaving little, if any, room for the use of carrybacks or carryovers. A taxpayer who has substantial NOLs, an accompanying large credit carryover, and high foreign tax rates cannot generate sufficient U.S. tax liability and credit limitation within the 5-year carryover period to absorb the unused credit.

4. This example illustrates that there is a conflict between the intended benefits of the election to take only the extended carryover period and the present restrictive carryover and indexing rules for the foreign tax credit. When the NOL election was enacted in the Tax Reform Act of 1976, it was noted that a reason for allowing the election to forego the carryback was to reduce the potential for losing foreign tax credits.

> Because of the interaction of the net operating loss rules and other provisions of the Code, a net operating loss carryback can in some cases actually increase a taxpayer's aggregate tax liability over the nine-year carryback and carryover period. For example, if a taxpayer has a loss to be carried back and if in the carryback year the taxpayer had foreign source income which resulted in no U.S. tax liability because

> of foreign tax credits, the net operating loss carrybacks would merely displace the foreign source income and accompanying foreign tax credits without providing tax benefit.
>
> General Explanation of the Tax Reform Act of 1976, H.R. 10612, 94th Cong., P.L. 94-455, p. 189.

For all the reasons outlined above, the carryover and ordering rules for the foreign tax credit are in disharmony with other credits and other related provisions of law. A consistent 15-year carryover and a FIFO ordering rule should be provided for the foreign tax credit.

Mr. **Conable**. I would like to thank Mr. Coffino for the vigorous work of the institute. You are a very lively group. I realize we are in a very technical area generally when we talk with you. This committee does not operate comfortably in technical areas.

Mr. **Coffino**. Thank you, Mr. Conable. The respect is mutual.

Mr. **Pease**. Mr. Duncan.

Mr. **Duncan**. Thank you, Mr. Chairman. I have no particular questions. I would like to thank the entire panel for your contribution and the sacrifice through which you have gone to appear before us today. I think these hearings are actually the most important hearings we have held in a long time. I am sorry that some of our colleagues are not here today, but I am sure they will read your testimony with great interest.

Thank you, sir. Thank you, Mr. Chairman.

Mr. **Pease**. I would like to thank all the members of the panel. I would like to ask our next panel to take the chair; Ms. Marjorie A. O'Connell and Ms. Gail Harmon.

Ms. O'Connell, you may proceed.

STATEMENT OF MARJORIE A. O'CONNELL, ESQ., O'CONNELL & ASSOCIATES, WASHINGTON, D.C.

Ms. **O'Connell**. Good afternoon, Mr. Chairman.

Thank you, Mr. Chairman, Mr. Rostenkowski, Mr. Conable, gentlemen. Thank you for giving me the opportunity to talk to you about H.R. 3475. I am going to limit my remarks to title II about domestic relations tax reform.

For more than 10 years I have specialized in this area of tax law and domestic relations law. For the last 4, I have worked with the staff members I see behind you to whom I am equally grateful with you for this progress that has finally come to fruition to simplify what is already a painful time for millions of divorcing Americans each year when it comes to the day they face the tax collector for what they have just gone through.

I applaud your effort to add your personal support to the introduction of this bill and to its rapid consideration, and we hope early passage and enactment.

I will rely on my written remarks for technical comment about the various provisions of title II. There are two things really I want to accomplish in talking to you this morning. The first is to ask you to remember who this constituency without a lobby is, and who this group has met in the tax system both at the Internal Revenue Service and in the courts. So I would like to tell you some things about them. Then once I hope you know more about them, I would like to call your attention to a couple places where I think that group is mischaracterized by the treatment it is given in the legislation and to suggest a little bit of change.

Overall, I would underscore again that all of the provisions of the bill are ones which I endorse heartily. As one who speaks all over the country and practices of counsel and is an expert witness in many States, I know many judges and systems of the domestic law that will be greatly relieved and enthusiastic for this work. Those are the decisionmakers; let's talk about the people who are affected by those decisions.

Last year we think there were approximately 1.8 million divorces in the United States. And we think that about 3.5 million taxpayers found themselves faced with a tax liability which many of them never expected, and which once they found out about they thought was inequitable and unfair. Here are some of the reasons that I think justify their view.

In the last 3 or 4 years there has been action, in six States that are common law States, to adopt statutes that would give community property nonrecognition tax treatment to the division of property between divorcing people. It is not very easy to live on one side of a State line and find out that as a matter of fact, you have to liquidate your business interest of 20 years to pay the capital gains taxes for a stock transfer that a judge has ordered you to make to a former spouse, while the guy on the other side of the State line doesn't owe any taxes and may continue in business side by side across the river, if you will, as your competitor.

That is wrong. It breeds the worse kind of dissatisfaction among taxpayers across the country, and they get that word to their State legislatures. They didn't have a forum here, and the Supreme Court said Federal law was clear about the result. So consequently, State laws are starting to be changed to make an end run around Federal tax law. And that is wrong. Certainly, anyplace where many people believe that noncompliance is the way to go, even if they take the blessing of a State law to get there, deserves attention and change.

Second, many people misunderstood what it meant for divorcing spouses when Federal law changed to, in effect, make gifts between spouses tax free. Regrettably, so, too, did many of their professional advisors across America. And so the second swell of misunderstanding arose, not only about what is in your State law, but also about what is in Federal law now. People came to get advice that, if they handled their divorce settlement before the decree were final, they wouldn't owe any taxes. It is no easier to be in the same foursome with a person who explains to you that he used that gimmick to avoid taxes completely, when you have just received advice that that is not Federal law and that it is not the right result.

Third, we know that the Treasury statistics show that the difference between the amount of alimony reported paid and deducted in 1981 and the difference reported received as income is some $800 million. Now all of that is probably not attributable to avoidance or misunderstanding, but it is attributable certainly to a lack of familiarity with a system that is considered too complicated to understand and to adhere to.

Finally, we know that in the last 18 months, people who couldn't resolve to their satisfaction with the Internal Revenue Service these unhappy situations, who plain just didn't believe that could be the law, have filed thousands of cases in the U.S. Tax Court. A lot of that docket you heard about in prior testimony are cases involving issues in this area.

Second, these cases have required some 80 published opinions of the Tax Court in a little over the last year. So a problem which has got its roots in the heart of families in America and what they care about, and multiple families, is not only bad for compliance purposes, it is bad for administration purposes and it is bad for litigation of those cases in the judicial system. Now the people who are involved in divorces, all those millions of them, aren't exactly the cigar-chewing, anxious-for-tax-avoidance people that some of you may have on your minds some of the time when you think about what Federal tax laws should guard against. They tend to be individuals who are hard pressed to support what becomes two family units, and in many, many cases, individuals who are supporting multifamily units.

I would submit that when we try to enhance compliance and we try to enhance revenue collection by making something more understandable and simple and respected, we ought not to leave in the system complexities which will continue to foster disrespect, just of a different rule. I would address myself specifically to the areas for changing the system of taxation of payments of alimony.

While the periodicity requirements currently in the law have been eliminated, a substitute has been added. It is difficult to even state the rule of the substitute. It is going to be hard to remember. It is going to catch a lot of individuals who don't expect it and, worse, it is never going to catch anyone who has any kind of a competent tax advisor because it can be planned around very effectively.

Consequently, I am afraid if there are any of the tax avoidance types who notwithstanding their domestic lack of bliss come into a lawyer looking only for tax advice and the best way out of their marriage from a tax point of view, they will be advised about it. But probably the other 3½ million Americans won't be. They again will be surprised about it.

Second, the requirement that payments that might be received for support by an individual which may be an entitlement of that individual's estate would keep those payments from being tax deductible is difficult and is also, I am afraid, looking to a group of people who are not really the typical American recipient of alimony payments, payments for support.

It would be a tragic case if under the rules that are designed here, the very precipitous death which makes somebody pass before all of their support payments may be made is the one which was the occasion of serious and substantial medical expenses being incurred in the last year of an individual's life, which when that individual's estate is liquidated to pay those expenses has no money to do so because the payments aren't going to be deductible to the payor anymore under this law. Consequently, the payor is able to get a State court to relieve liability to make the payments.

I don't think we have in mind what really happens to divorcing people if we think that they would for tax avoidance purposes jeopardize their own position as a recipient and somehow minimize the amount of support to which they might be entitled and to which they legitimately believe their estates may be entitled for support responsibilities the estates may have incurred.

So in summary, I urge you to think about that important and substantial segment of America that you have helped. I applaud your introduction of this bill and its completeness. Chipping away piecemeal at this problem would only have made a bad situation so much worse.

Thank you for the opportunity to talk to you and I would be pleased to take questions if you have any when the panel is concluded.

Mr. PEASE. Thank you very much, Ms. O'Connell.

[The prepared statement follows:]

STATEMENT OF MARJORIE A. O'CONNELL, O'CONNELL & ASSOCIATES, WASHINGTON, D.C.

SUMMARY

I. The law of federal divorce taxation has seen major new complexities in several areas.

A. These complexities are the result of efforts by taxpayers to avoid tax rules which are viewed as unjust and inequitable.

B. Several states have adopted laws principally intended to change the federal tax consequences of divorces. The number of cases involving divorce tax issues is growing and several recent trends promise that many more cases will be brought in the future.

II. H.R. 3475 is a good first step toward establishing a rational, cohesive set of tax rules for all divorces.

A. Section 202 would establish that a marital dissolution is an inappropriate time for making a transfer between spouses into a taxable event. The carryover basis provisions preserve the unrealized "gain" for future taxation.

B. Section 203 would substantially simplify the alimony provisions of the Code by eliminating most of the artificial and cumbersome requirements. Section 203 could be improved.

1. Spouses should not have to live apart for temporary support payments to be alimony. Property transfers should be only the transfer of "hard assets" and of vested, choate property rights that existed during the marriage.

2. Support needs of the recipient may continue past death and a post-death prohibition is not necessary.

3. The 12-month 50-percent rule is the last vestige of the current periodicity requirements. This rule is unworkable and unnecessary.

4. Present law rules about fixed child support should be retained or the parties' flexibility should be increased by allowing child support payments to be designated as taxable to the recipient.

III. Sections 204, 205 and 206 would make related areas more consistent and workable.

A. Section 204 would make the dependency exemption and related rules more rational and understandable to taxpayers.

B. Section 205 would make innocent spouse treatment on joint returns available to deserving spouses who are now excluded. I urge the enactment of this provision. For abandoned spouses in community property states, the legislation would correct a serious problem.

C. Section 206 would create a long overdue conformity between the estate tax rules about marital rights as consideration and the gift tax rules.

STATEMENT

I want to thank the Ways and Means Committee and Chairman Rostenkowski for inviting me to testify about H.R. 3475, the Tax Law Simplification and Improvement Act of 1983. I shall address Title II, the Domestic Relations Tax Reform Act of 1983.

I am the author of "Divorce Taxation," a loose-leaf service for domestic relations lawyers and tax practitioners. I have been actively involved in efforts to modify federal tax law about divorce. I have lectured frequently about the problems in current law at professional seminars.

I am also an attorney who practices in both the domestic relations and tax fields. Like other practitioners, I am interested in having Congress fashion a realistic set of tax rules that balances the needs of divorcing spouses with the revenue raising concerns of the federal government.

In the year and a half since my book was first published, the law of federal divorce taxation has seen major new complexities in several areas. These complexities are largely the result of efforts to avoid tax rules which taxpayers feel are unjust and inequitable. Six states have passed laws that attempt to achieve for their citizens the beneficial federal tax treatment on property transfers previously limited to only two noncommunity property states, Oklahoma and Colorado. Divorce tax cases are being filed at increasing rates. The Tax Court alone has issued more than 80 published decisions about divorce tax issues in the last 18 months. Because of the small amount of tax frequently involved in these cases, a much larger number were disposed of without opinions. The unlimited marital gift deduction created in 1981 has been touted by some as a method to avoid federal tax on property transfers. Many of these purported gifts raise serious tax compliance questions. The gap between alimony income reported and alimony deductions taken may be as large as $800 million per year. The often devastating tax effects of a divorce are a contributing factor to the abysmal record of missed child support payments by noncustodial parents.

The problems in current divorce tax law arise from several Code provisions. H.R. 3475 is a very good first step toward establishing a rational, cohesive set of rules for divorce taxation. This work of the Ways and Means Committee is an indication of the Committee's commitment to make the tax system equitable for all taxpayers, regardless of rules which may differentiate them because of the area in which they live or of their financial means which may affect the quality of tax advice they receive. There is no organized lobby of divorcing spouses to push for passage of H.R. 3475. The public must rely on the common sense of the Members that the needs for reform are real and urgent. I urge the Committee to continue its efforts on this bill.

I would like to address briefly the specific provisions of H.R. 3475. Section 202 would establish a uniform nonrecognition rule for transfers between spouses, including divorce-related transfers. Since the Supreme Court's decision in *U.S.* v. *Davis* in 1962, divorcing taxpayers have struggled with the tax burden created by most types of property transfers. I wholeheartedly support the theory of Section 202 that a marital dissolution is an inappropriate time for making a transfer between spouses into a taxable event. The carryover basis provisions in the section preserve the unrealized gain for future tax. The "gain" in a *Davis* exchange never produces cash for the party who must pay the tax. Section 202 covers all transfers between spouses and divorced spouses when the transfers are related to the divorce. I suggest that the legislative history make it clear that the term divorce also includes annulments and marriages which are void ad initio due to violation of state law. I strongly recommend the provisions allowing spouses to apply these new rules to future transfers under divorce decrees before the effective date be retained.

Section 203 would dramatically revise the rules about alimony payments. The general thrust of the rules would substantially simplify the alimony provisions of the Code. By eliminating most of the artificial and cumbersome requirements for periodic payments and contingencies, these new rules would aid divorcing taxpayers in setting their alimony obligations. Section 203 would make major improvements in the taxation of alimony.

Nevertheless, I have several recommendations for revisions. New section 71(b)(1)(C) makes statutory the present rule that payments for property transfers are not alimony. This is a necessary restriction for alimony payments. I recommend a clarification that property transfers for this purpose be only the transfer of so-called "hard assets" and of vested, choate property rights that existed during the marriage. This rule should not apply to any release of an inchoate property right such as rights under an equitable distribution statute.

New section 71(b)(1)(D) would require that the spouses not live in the same household when the payments are made. The issue of when spouses are "separate and apart" has been the subject of conflicting recent court decisions. H.R. 3475 would establish a clear rule, however, the rule if strictly construed would have an undue adverse impact on many divorcing parties. Frequently spouses will live in the same house for a short period of time while support payments are made but will file separate returns, for the year. If these payments are not taxable alimony, the date of physical departure would be an issue for dispute. I suggest that the payments be taxable alimony if the spouses separate within a fixed time after the payments begin.

Section 71(b)(1)(E) would prohibit alimony treatment for any payments which continue past the recipient's death. While support needs of the recipient is the cornerstone of alimony, death does not always terminate those needs. For example, spouses may value the recipient's support rights for life at $200,000 based on his or her life expectancy. Instead of paying this amount for life, the payor may want to pay it over a shorter period. If the recipient dies before the end of the shorter period, any continuing payments would be in respect of a support obligation. The recipient may have post-death obligations that those payments would run to, such as the pay-off of debts incurred to meet support needs during life. This is often the case where serious medical problems cause the recipient's precipitous death. While I understand the genesis of the post-death prohibition, I urge that the committee seriously consider deleting this provision from the bill.

New section 71(b)(1)(F) provides that the alimony must be paid in more than one payment with at least 50 percent of the amount being expected to be paid more than 1 year after the first payment. This rule is the last vestige of the current periodicity requirements that has caused so many problems. The apparent evil this rule strikes at is a lump sum payment for support in the year of divorce. This type of arrangement is rarely done and virtually never for tax reasons. This is perverse tax planning for the recipient whose tax liability is seriously multiplied by the higher rates. Nevertheless, I submit that this 50-percent rule is an unnecesary complication. Moreover, the application for this rule would require a subjective evaluation of future events to determine what is the time period in which it is "reasonable to expect" for payments to be made. While temporary support orders are exempted, written separation agreements are not. These agreements may provide for support only until a divorce is granted. With the uncertainties of court dockets, a taxpayer would have a difficult time to show what time frame is reasonable for the payments. The rule if retained should apply to payments made under any "divorce or separation instrument", as that term is defined in new section 71(b)(2).

New section 71(c) would continue present law about fixed child support payments as interpreted by the Supreme Court in *Commissioner* v. *Lester,* 336 U.S. 299 (1961). Under this case, payments made "for the support of a spouse and children" are all alimony. I believe the statute should contain at least this continuation of present law. I urge serious consideration of a further refinement. Parties also should be allowed to designate fixed child support as taxable to the recipient parent and deductible by the payor parent. This would accomplish two beneficial results. First, *Lester* has proven to be a trap for uninformed taxpayers. Divorcing spouses may enter arrangements without understanding the tax difference of fixing child support. Second, both state and federal law often give greater protection to enforcing solely child support obligations. For example, the amount designated for support in a *Lester* arrangement has been held not exempt from a wage levy for federal taxes, while a fixed child support obligation would have been exempt under section 6334(a)(8). Thus a payor's means to pay child support may be removed by the very federal taxing system one would hope would encourage payment or at least be neutral. If parties could fix a separate child support payment but preserve its alimony treatment, they would be more likely to fix an amount for child support payments. This would help enforcement of child support obligations.

New section 215(c) would give the Treasury the authority to require disclosure and reporting of taxpayer identification numbers for alimony payments. I suggest that the transferor also be required to disclose the address where payments are made since more than one Service Center may be involved. I support the $50 penalty as a reasonable method to ensure compliance.

Section 204 of H.R. 3475 would change the dependency exemption and related rules. I urge the enactment of all of these changes. They are a rational workable response to what has been an unduely troublesome area for the IRS. Dependency exemptions have relatively small tax effects on taxpayers, but they have caused sizeable audit and litigation problems for the IRS.

Section 205 of H.R. 3475 would change the innocent spouse rules in two ways. By reducing the threshold amounts for the understatements and expanding the nature of items covered, H.R. 3475 would make innocent spouse treatment on joint returns available to many deserving spouses who are now excluded. I urge the enactment of this provision, with one revision. The expansion of the covered items to include deductions and credits as well as income omissions should extend further than only to deductions and credits for which there is "no basis in fact or law" in new Section 6013(e)(2)(B). It should also include any deductions or credits for which there is "no substantial authority." Thus, the effort to relieve truly "innocent spouses" of liability would not be thwarted by excluding those whose spouses took deductions or credits for which there may have been some basis in fact or law, but which were otherwise not allowable.

The second change would affect spouses in community property states where the nonearner spouse is taxed solely due to the application of the community property rules. This would correct a problem that has plagued abandoned and separated spouses in community property states.

Section 206 of H.R. 3475 would conform the estate tax rules about marital rights as consideration with the gift tax rules. This conformity has been long overdue and I support the change.

Thank you for the opportunity to testify. I congratulate Representatives Rostenkowski and Conable for taking this initiative. I urge the Ways and Means Committee to move as quickly as possible toward enactment of this important legislation.

STATEMENT OF GAIL M. HARMON, COUNSEL, ON BEHALF OF THE WOMEN'S LEGAL DEFENSE FUND AND THE WOMEN'S EQUITY ACTION LEAGUE

Mr. PEASE. Ms. Harmon, you may proceed.

Ms. HARMON. Thank you. My name is Gail Harmon. I am testifying on behalf of the Women's Legal Defense Fund and the Women's Equity Action League in favor of the proposed revisions to the so-called innocent spouse rule.

Prior to 1971, the general rule was that when a husband and wife filed a joint income tax return, each would be jointly and severally liable for any deficiencies, interest, or penalties. A claim of innocence of the wrongdoing would not even be considered. In 1971, subsection (e) was added to section 6013 of the code. This so-called innocent spouse provision grants relief in those rare cases in which the following five requirements are met: One, a joint return was filed; two, there was an omission from gross income attributable to the guilty spouse; three, the omission constituted an amount in excess of 25 percent of the amount stated in gross income; four, the innocent spouse established that he/she neither had knowledge of the omission nor reason to know of it; and five, considering all the facts and circumstances—most notably, whether the innocent spouse significantly benefitted from the omission, it would be inequitable to hold the innocent spouse liable.

The legislative history of this section makes clear that Congress intent was to bring Government tax collection practices into accord with basic principles of equity and fairness. However, the change enacted did not go far enough, and basic inequities still exist.

The proposed bill now before you will increase the instances in which the courts are able to achieve the equitable results Congress originally intended. Relief would be available in all cases of substantial understatement of tax whether the understatement is due to omitted income or inflated deductions. Substantial understatement would be broadly defined to allow an increased amount of innocent spouse taxpayers to qualify. In addition, special rules would provide equal treatment for innocent spouse taxpayers in community property States.

The proposal substitutes the broader category of substantial understatement of tax for understatements of gross income, correcting the problem that current law ignores cases involving errors in deductions or credits. It is just as unfair to impose liability on an innocent spouse for underpaid taxes due to overstated deductions as it is to impose liability for underreported gross income.

In Spaulder, a wife was denied relief when an erroneous deduction in a joint return improperly reflected losses on the sale of securities as ordinary rather than capital losses. In Resnick, the coin-dealer husband overstated the cost of goods sold. Again relief was denied because the understatement of income was held attributable to an erroneous deduction rather than to unreported income.

The present statute usually applies to the rare case of an innocent nonworking spouse of a criminal who fails to report his illegal income to the IRS. This new formulation is better adapted to the current reality of two income families. In the case of a dual professional household, each spouse is responsible for his/her individual business accounts and would contribute only the final figures for inclusion on the joint return. Each spouse would have no reason to doubt the information from the other spouse and probably little access to the raw data provided in the information.

Second, the bill provides relief for more innocent taxpayers since it will apply to all understatements of tax exceeding the lesser of 10 percent or $500. Too often the Federal tax law provides relief only to the very rich. This proposal provides relief to innocent spouses up and down the income scale.

Third, the proposed amendment would eliminate the provision requiring that the innocent spouses prove that they did not benefit directly or indirectly. The significant benefit doctrine has proven to be a vague concept that will become worthless when applied to understatements of tax as opposed to omitted income.

Finally, this amendment provides relief for the particular problems faced by innocent spouses in a community property State. The property law of these States provides that the income of one spouse is attributable to the other spouse even though separate Federal tax returns are filed. Under the present Federal statute, relief is not available when separate returns are filed. Take, for example, the case of Mary Lou Galliher, who resited in the community property State of Texas. She met all of the other tests of the statute but she was denied relief of section 6013(e) because she had filed a separate return. It seems only fair that innocent spouses in community property States should have the same rights as those residing in noncommunity property States.

Congress attempted to remedy existing inequities in the area of joint and several liability by enacting the innocent spouse provisions. However, many injustices still exist and many innocent spouses are denied relief. The bill that you are looking at today will insure the relief that Congress originally intended.

[The prepared statement follows:]

STATEMENT OF GAIL M. HARMON ON BEHALF OF THE WOMEN'S LEGAL DEFENSE FUND AND THE WOMEN'S EQUITY ACTION LEAGUE

Good morning. My name is Gail Harmon. I am a practicing tax attorney here in Washington and a partner in the law firm of Harmon & Weiss. I am testifying on behalf of the Women's Legal Defense Fund and the Women's Equity Action League. I would like to thank the committee for the opportunity to comment today on the proposed revisions to section 6013(e) of the Internal Revenue Code, the so-called innocent spouse rule.

Prior to 1971, the general rule was that when a husband and wife filed a joint income tax return each would be jointly and severally liable for any deficiencies, interest or penalties. A claim of innocence of the wrongdoing would not even be considered. In 1971, subsection (e) was added to section 6013 of the Code. This so called innocent spouse provision grants relief in those rare cases in which the following five requirements are met: (1) a joint return was filed; (2) there was an omission from gross income attributable to the "guilty" spouse; (3) the omission constituted an amount in excess of 25 percent of the amount stated in gross income; (4) the innocent spouse established that he/she neither had knowledge of the omission or "reason to know of it"; and (5) considering all the facts and circumstances (most notably, whether the innocent spouse "significantly benefited" from the omission), it would be inequitable to hold the innocent spouse liable.

The legislative history of this section makes clear that Congress's intent was to bring government tax collection practices into accord with basic principles of equity and fairness. However, the change enacted did not go far enough, and basic inequities still exist.

The proposed bill now before you will increase the instances in which the courts are able to achieve the equitable results Congress originally intended. Relief would be available in all cases of "substantial understatement of tax," whether the understatement is due to omitted income or inflated deductions. "Substantial understatement" would be broadly defined to allow an increased number of innocent spouse taxpayers to qualify. In addition, special ruels would provide equal treatment for innocent spouse taxpayers in community property states.

The proposal substitutes the broader category of "substantial understatement of tax" for understatements of gross income, correcting the problem that current law ignores cases involving errors in deductions or credits. It is just as unfair to impose liability on an innocent spouse for underpaid taxes due to overstated deductions as it is to impose liability for underreported gross income.[1]

The present statute usually applies to the rare case of an innocent non-working spouse of a criminal who fails to report his illegal income to the I.R.S. This new formulation is better adapted to the current reality of two income families. In the case of a dual professional household, each spouse is responsible for his/her individual business accounts and would contribute only the final figures for inclusion on the joint return. The other spouse would have no reason to suspect that the information provided was not accurate. He/she would have no knowledge of underestimated business income or inflated deductions claimed by the other spouse.

Second, the bill provides relief for more innocent taxpayers since it will apply to all understatements of tax exceeding the lesser of ten percent or $500. Too often the federal tax law provides relief only to the very rich. This proposal provides relief to innocent spouses up and down the income scale. The original Senate report on section 6013(e) indicates that one of the primary purposes for the current 25 percent requirement was to establish a clear standard and to assure judicial economy. The proposal substitutes another precise standard and meets the desire for judicial economy through forces of the market place, namely the high cost of legal representation, which will deter insubstantial claims. More important, the proposed lower threshold would be consistent with the remedial nature of the original statute.[2]

Third, the proposed amendment would eliminate the provision requiring that the innocent spouses prove that they did not benefit directly or indirectly. The "significant benefit" doctrine has proven to be a vague concept that will become worthless when applied to understatements of tax as opposed to omitted income. When the tax fraud relates to failing to report substantial amounts of embezzeled funds or gambling winnings, one may be able to show that the innocent spouse never received the benefit of these funds. However, when the error relates to inflated deductions there is no hidden income from which to benefit. In addition, if the focus is upon understatements of tax, the lack of substantial benefit can be proved only in those cases in which the marriage has already broken down and the parties are separated.

Finally, this amendment provides relief for the particular problems faced by innocent spouses in a community property state. The property law of these states provides that the income of one spouse is attributable to the other spouse even though separate federal tax returns are filed. Under the present federal statute, relief is not available where separate returns are filed. Take for example, the case of *Mary Lou Galliher,* who resided in the community property State of Texas. She met all of the other tests of the statutes but she was denied relief of section 6013(e) because she had filed a separate return. It seems only fair that innocent spouses in community property states should have the same rights as those residing in noncommunity property states.

Congress attempted to remedy existing inequities in the area of joint and several liability by enacting the innocent spouse provisions. However, many injustices still exist and many innocent spouses are denied relief from liability. To the extent these inequities exist, the reform has failed. The bill which you are debating today will ensure the relief that Congress originally intended.

---

[1] Two instances of the unjust denial of relief follow. In Spaulder, (TCM 1972-144) a wife was denied relief when an erroneous deduction in a joint return improperly reflected losses on the sale of securities as ordinary rather than capital losses. In *Resnick,* [63 TC 524 (1975)], the coin-dealer husband overstated the cost of goods sold. Again relief was denied because the understatement of income was held attributable to an erroneous deduction rather than to unreported income.

[2] The case of *Estate of Klein* v. *Commissioner* demonstrates the inequities in the 25 percent of gross income test. There, the husband reported $91,000 in net partnership income but $45,000 of miscellaneous income in dividends, interest and the like. However, because the husband's gross income was based upon his distributive share of partnership income before partnership deductions, it was quite large and prevented the spouse from meeting the 25 percent test.

Mr. HANCE [presiding]. Thank you very much.

Mr. Pease.

Mr. PEASE. No questions.

Mr. HANCE. Mr. Conable.

Mr. CONABLE. Thank you.

There is a great deal being made of claims of malpractice against lawyers in domestic relations issues because they have failed to ask the right questions. Are many of these tax related?

Ms. O'CONNELL. Yes, they are.

Mr. CONABLE. Because of the complexities of tax laws and their special impact on people seeking divorces?

Ms. O'CONNELL. Yes, that is right. It is not usual for a divorcing individual to think they need a tax lawyer. They think they need a domestic relations lawyer only. I am afraid as the increasing number of decisions on malpractice issues that involve misadvice or lack of advice about tax issues increase, people realize that more. If anything, that has increased the ground swell in the bar and other tax advising professions for clarity and consistency and simplification which is a lot of what this bill will accomplish.

Mr. CONABLE. I was curious to know if that was part of the reason malpractices are on the upswing.

Ms. O'CONNELL. It is a significant part of the reason in the domestic area, sir.

Mr. CONABLE. Thank you.

Mr. HANCE. Mr. Duncan.

Mr. DUNCAN. I have no questions. I want to thank the two fine witnesses.

Ms. O'CONNELL. Thank you.

Mr. HANCE. I have a question I guess to both of you. I apologize to Ms. O'Connell that I didn't get to hear her entire statement. A constituent complained to me not long ago that she had gone through a divorce. At the time of the divorce, her husband explained that since he had been working for the 5 years they had been married and that he had really earned everything during that period of time, that he was willing to take both the liability and the assets and give her a small settlement. Part of the problem was that she didn't have good representation at the time of the divorce. Her ex-husband then took off to places unknown, and she had assumed that he had taken all liabilities in the settlement.

The next thing she knows, the IRS informs her they want some $8,000, and that unbeknownst to her, he had not paid his taxes. And IRS was going out of their way to collect it from her because they couldn't find him but they could find her.

I don't know that there is an actual solution to this problem.

Ms. O'CONNELL. Well, sir, I would assume the IRS was going after her, as you say, because she had a joint return under which she converted any liability that might have been her husband's alone if she had filed a separate return to hers under that law. They couldn't find him so she became one who might be eligible for innocent spouse treatment under current statute. But if she wasn't entitled to innocent spouse treatment under the current statute, I suppose that is because the Service told her she failed to meet one of several technical tests.

It could have been about the amount of tax liability, which this bill addresses by substantially reducing the amount of understatement which clicks in the innocent spouse provisions. The Service doesn't have available to it a chance to resort to equity and say it ought not do wrong in those hard cases. The Service must also leave the impression that you cannot, by relying on a relationship between married individuals, manage to avoid your tax liability and leave the jurisdiction because the Service wouldn't go after someone who doesn't seem able to pay.

I think what is done in H.R. 3475 to relieve innocent spouses who indeed had no knowledge if they did really sign the return about what its contents were, or didn't do what attorneys might call a due diligence audit of the underlying facts, is significantly important and likely would relieve the situation of your individual as I can guess what her liability must have been or arisen from.

Mr. HANCE. She was very concerned because they were about to attach her bank account.

Ms. O'CONNELL. That is correct.

Mr. HANCE. All $180; and she was afraid she was going to lose her car, the only thing she got out of the divorce that was paid for. The end result would be that she wouldn't have a job and would wind up on welfare. The Federal Government would lose money as the end result.

Ms. O'CONNELL. Indeed, you would, sir. If I can tell you about a case that puts Mr. Conable's question and yours together, and this one actually happened. You know, there is somebody who made a valuable mistake here. It is probably the person who rendered incomplete advice about either getting on that joint return in the first place or second, let somebody sign a property settlement agreement that says, "I will be responsible for all your tax liabilities in any year when we filed a joint return that was appropriate to file." That person is a professional adviser.

There is a case arising in the State of Virginia that has the same underlying facts that yours does about property settlement with an individual taking a house, a family home. The woman who lived in the family home was chagrined to find out that the Service filed a levy, a lien against the house and that they were going to execute on it and foreclose because her husband's tax liability which his attorney had negotiated with the Internal Revenue Service set a higher amount than he was able to pay. And while she was not relieved of liability, she also had the only asset able to meet the liability that somebody else negotiated for her.

No one ever said the words to her innocent spouse. There is a Federal District Court opinion in Virginia tragically rendered on December 23, 1981, that says that levy, lien against the property may be executed. That the property may be foreclosed on. And it goes to remark about the quality of advice that would let an individual go twice through the taxing system, once on the return and once in negotiating a settlement, and let someone go through a property settlement agreement in connection with a divorce, and never bother to explain to that person what her exposure was or what little protection she might have under the applicable Federal statute then.

So I think you gentlemen are onto the problem and where the angry Americans are, and maybe a way to save a lot of people who don't get complete advice but get harsh results.

Mr. HANCE. Did you want to add anything to that?

Ms. HARMON. No; I think she stated it fully.

Mr. HANCE. Any additional questions?

Thank you very much.

Ms. O'CONNELL. Thank you.

Mr. HANCE. The next panel is Mr. David J. Silverman, chairman, National Association of Enrolled Agents; Jim Jones, Government Research and Development Foundation, Jules Levinson, and George Webster with the Colt Industries; Vester T. Hughes, Southwest Small Business Study Group; and William J. Lehrfeld, Shriners Hospitals for Crippled Children.

STATEMENT OF DAVID J. SILVERMAN, CHAIRMAN, GOVERNMENT RELATIONS COMMITTEE, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. SILVERMAN. Thank you, Mr. Chairman.

Mr. HANCE. Mr. Silverman, we will hear from you first.

Mr. SILVERMAN. Good afternoon. My name is David Silverman, I am chairman of the Government Relations Committee of the National Association of Enrolled Agents whose members are enrolled to represent taxpayers before the Internal Revenue Service.

Mr. Chairman, I would like to thank you for the opportunity to make the views of the National Association of Enrolled Agents known to your committee. While our society supports the passage of the Tax Law Simplification and Improvement Bill of 1983, H.R. 3475, I intend to limit my testimony to that section of the bill that would allow taxpayers to be represented in the tax court under the small case procedure by enrolled agents and CPA's. The small, or S procedure was enacted to provide taxpayers with an opportunity for an informal or simplified proceeding when litigating a tax dispute under $5,000 with the Internal Revenue Service. However, taxpayers find themselves in the unenviable position of having to disassociate themselves from the enrolled agent or CPA who prepared their tax return if they chose to avail themselves of this case procedure.

The cost of this disassociation causes the small case to take on aspects and the costs of major litigation. The small case procedure remains small in name only. Since most small case petitions involve factual issues where the IRS refuses to accept a taxpayer's substantiation of the deduction, the National Association of Enrolled Agents believes that the enrolled agent who prepared the tax return being familiar with the facts at issue and having satisfactorily demonstrated their expertise in the field of taxation are extremely qualified to represent their clients in these types of tax court disputes.

After reviewing the information that appears in 1981 and 1982 annual reports of the Chief Counsel of the Internal Revenue Service, I feel that the reasons for enacting this legislation are compelling. I would like to submit to the committee at this time page 75 of the Chief Counsel's annual report for 1981 and page 28 of the 1982 annual report. This indicates that the number grew from 3,100 in 1977 to 10,500 in 1981 and 9,800 in 1982. The tax court hears approximately 1,000 cases a year out of the pending 54,000 cases.

Over 90 percent of the cases disposed of are accomplished through the settlement process. This proposal will dramatically increase this settlement process. Through my service in 1982 as a member of the commissioner's advisory group, I became acutely aware of the pro se problem that both the Chief Counsel's office and court is currently facing. No other single problem on the advisory group's agenda received as much attention than that of the pro se petitioner.

In conversations with me, Kenneth W. Gideon, former Chief Counsel to the Internal Revenue Service stated that he would prefer to see petitioners with representation than without representation. The majority of the pro se petitioners are not aware of the documentation required by law in order to properly substantiate a tax deduction. This lack of understanding consumes an inordinate amount of the court's time. Most of the small case petitions involve factual disputes. Who is better qualified to represent the taxpayer's position in a small case hearing involving a factual issue than the enrolled agent or certified public accountant who prepared the return and is familiar with the facts.

The U.S. Tax Court is strained under its current caseload. It simply does not have the resources to dispose of all cases currently before it. A disproportionate amount of the court's time is taken up with the pro se petitioner.

The National Association of Enrolled Agents does not feel that the correct solution to this problem is increased governmental appropriations in order to hire more trial judges and Government attorneys. A great deal of scholarly and practical work has been done in this country with respect to techniques to reduce court dockets. It can be demonstrated that these techniques when properly applied have in fact reduced court dockets dramatically.

The National Association of Enrolled Agents believes this bill is one that would enhance rights of taxpayers, address the pro se problem and reduce the number of docketed cases through the settlement process without the need for additional appropriations.

Again I would like to thank the committee for the opportunity to speak this afternoon and to let you know that the National Association of Enrolled Agents applauds the work that the committee is doing in order to simplify our tax laws.

Thank you.

Mr. HANCE. Thank you, Mr. Silverman.

[The information referred to follows:]

Tax Litigation

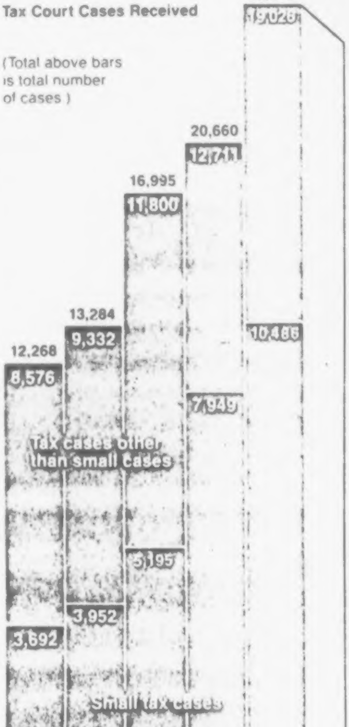
The Tax Litigation Division determines and coordinates the legal position of the IRS in order to assure consistency in all cases litigated in the United States Tax Court and all cases for refund of taxes and certain suits for declaratory judgment instituted by taxpayers in the United States district courts and the Court of Claims. If the IRS loses a case, the division determines, and advises the IRS with respect to Tax Court cases, whether to acquiesce or nonacquiesce in the decision and, with respect to other adversely decided cases, advises the Department of Justice whether or not to appeal.

During the 1981 fiscal year, a number of significant cases were decided.

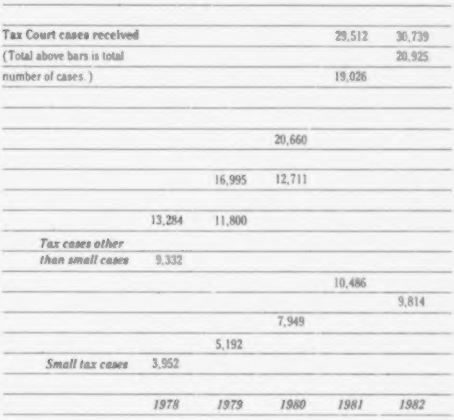
- In *Rowan Companies, Inc. v. United States*, the Supreme Court ruled against the IRS, holding that Congress intended the definition of "wages" to be interpreted in the same manner for FICA and FUTA withholding as for income tax withholding, and, therefore, when meals and lodging provided by the employer are excluded from income tax withholding, they are also excluded from FICA and FUTA withholding.
- In *United States v. Darusmont*, the Supreme Court held that the application of an income tax statute to the entire calendar year in which the statute was enacted did not per se violate the Due Process Clause of the Fifth Amendment.
- The Supreme Court ruled for the IRS in *HCSC-Laundry v. United States*, holding that hospital-shared service organizations cannot qualify for exempt status under subsection 501(c)(3), but must qualify, if at all, under subsection 501(e) which governs cooperative hospital service organizations.
- The Supreme Court ruled for the Government in *Commissioner v. Portland Cement Co. of Utah*, holding that for purposes of computing gross income from mining by the proportionate profits method which, in turn, governs a taxpayer's depletion deduction, the first marketable product is finished cement, whether sold in bulk or bags, and that the costs of bags, bagging, storing, shipping, and selling should be included in the proportionate profits computation as nonmining costs.
- The Supreme Court ruled against the Government in *United States v. Swank*, holding that a provision in a coal mining lease permitting termination by either party on 30-days notice did not preclude the lessees from having an "economic interest" in the coal in place which would entitle them to a depletion allowance under sections 611 and 613.
- In *Diedrich v. Commissioner*, the Eighth Circuit ruled for the IRS, holding in direct conflict to previous net-gift holdings in the Fourth, Fifth, and Sixth Circuits, that a donor realized income on the gift of property to his children, who agreed to pay the donor's gift tax liability, to the extent of the excess of the donor's tax liability over his adjusted basis in the property transferred, an issue involving approximately 20 pending cases and between 4 and 5 million dollars.

Tax Court Cases Received

(Total above bars is total number of cases.)

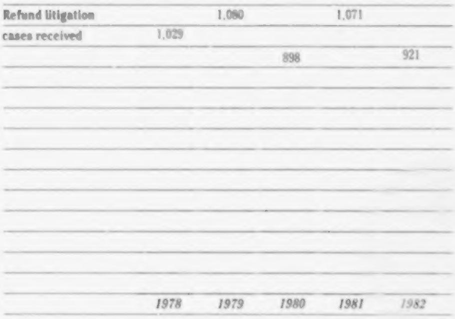


	Status	*Court*	*Non-court*	*Total*
Receipt and disposal of general litigation cases	Pending Oct. 1, 1981	14,266	1,682	15,948
	Received during year	22,452	5,663	28,115
	Disposed of	19,793	5,879	25,672
	Pending Sept. 30, 1982	16,925	1,466	18,391



Tax Court cases received

(Total above bars is total number of cases.)



Refund litigation cases received

members of other barter exchanges to report income and the tendency to report the income in the wrong year provided a reasonable basis for believing the members of the Columbus Trade Exchange may have failed to comply with the internal revenue laws.

TEFRA reduced delays in summons enforcement, since taxpayers no longer will be able to stay enforcement of a third-party recordkeeper summons simply by notifying the recordkeeper not to comply. Instead, objecting taxpayers have to file suit to quash the summons. TEFRA also clarified the Supreme Court decision in *United States v. LaSalle National Bank* by providing that the IRS may use summonses for criminal purposes as long as a referral to the Department of Justice is not in effect.

Tax Litigation

The tax litigation division assures that the legal position of the IRS is consistently presented in all refund cases and cases litigated in the Tax Court, and attorneys from the division argue most of the Tax Court motions – approximately 1,000 a year – set for hearing in Washington, D.C.

The division improved its efficiency in handling the increasing number of Tax Court cases. With a staff approximately the same size as last year's, it increased case closings 29 percent during the year. This increased productivity resulted primarily from the establishment of streamlined procedures for handling small cases and the development of case precedents in significant tax shelter areas to facilitate settlement.

The special trial attorney program finished the year with 169 groups of cases in its inventory, including many of the largest tax shelter groups in the country. For instance, approximately 1,400 separate cases, referred to generally as the London options cases, were consolidated and set for trial in Los Angeles on Jan. 31, 1983.

On June 15, 1982, the Supreme Court in *Diedrich v. Commissioner* upheld the government's longstanding position regarding the income taxation of a net gift transaction, holding that a donor who makes a gift of property on condition that the donee pay the resulting gift tax realizes taxable income to the

Mr. HANCE. Mr. Jones.

STATEMENT OF JIM JONES, MANAGING DIRECTOR, GOVERNMENT RESEARCH AND DEVELOPMENT FOUNDATION

Mr. JONES. Thank you, Mr. Chairman.

I am Jim Jones, a semiretired businessman. I am also founder of the Government Research and Development Foundation which is a nonprofit foundation dedicated to public policy research. I finance the foundation which is staffed largely by volunteers. For the past 7 years I have worked hard to bring about tax simplification and reform.

I want to emphasize, Mr. Chairman and members of the committee, how heartening it is to see the idea of tax reform and improvement begin to take concrete form in the provisions of H.R. 3475.

This bill will do two important things. First, it will eliminate or substantially simplify some of the highly complex provisions of the current Federal income tax system. Second, the bill will offer dramatic proof that we have the beginnings of the idea that we do not have to suffer forever under the yoke of the current tax system. There is a way out. There is hope. There can be a simpler and fairer tax system. I see H.R. 3475 as the first of what could be many more steps that could result in a fair, simple, neutral, and efficient tax system.

H.R. 3475 treats some of the symptoms, but it does not really attack the root causes of the disorder that plagues our tax system. The heart of the problem is this: The current system is based on net income, which is determined by figuring gross income and subtracting deductions, exemptions, and so on. This is the net income tax, or NIT system.

HR. 3475 tries to rationalize and simplify some of the myriad provisions that have been built up over the past 70 years. The bill addresses some of the more important areas of concern, but unfortunately there are many more. The Congress adds to the complexity and confusion just about every time it passes a new tax bill. The Congress can reform the law for one group one year, only to find another group howling for similar treatment the next year. And so it goes in a vicious circle.

One of the more troubling consequences of the NIT system is its unfairness to business. A company that is well run and makes good profits is highly taxed. A poorly run business, which loses money, pays little or no tax. To illustrate this point, imagine that all companies in the country merge until there are only two big conglomerates left. One is well managed and turns a nice profit. The other is poorly managed and loses money. If you ask the question, "Which company will pay tax under NIT," the answer is, of course, the profitable company. That company in effect subsidizes the unprofitable company.

It is these larger dimensions of tax reform that ultimately must concern this committee and the Congress. Eventually, it seems to me, this committee must face the necessity of overall reform of the tax system. Mere reworking of the current system will not be enough. The current system is beyond serious redemption.

Rather, we need to find a new way of doing things, an altogether new approach to taxation of our citizens and businesses. Tax reform should be based on sound principles as well as good intentions. I commend to the committee these four basic principles: equity, simplicity, neutrality, and efficiency.

I submit that the gross income tax, the GIT system, meets these criteria. GIT would impose a single rate of taxation on all gross income, which consists of gross receipts less cost of inventory. Business would collect taxes for the Government from their business activities.

GIT is a simple, fair, and efficient method of taxation. Moreover, it is really neutral and would eliminate the tax distortions that now afflict the marketplace. We need to return to a general reliance on market forces, rather than tax advantages, to guide individual and business economic decisions.

In closing, let me again state my support for H.R. 3475 as the kind of tax simplification measure that will at least lessen the pain of the current system.

Allow me to urge the committee to aim higher and try harder, and realistically to consider the case for fundamental tax reform.

Attached are my extended remarks for your consideration.

Thank you.

Mr. HANCE. Thank you very much.

[The prepared statement follows:]

STATEMENT OF JIM JONES, MANAGING DIRECTOR, GOVERNMENT RESEARCH AND DEVELOPMENT FOUNDATION

The Congress is approaching a crossroads in terms of tax simplification and reform. Public pressure for fundamental reform has been building for years: study after study by academics, pollsters, the media, and the Internal Revenue Service itself shows that the public is disenchanted with the current method of collecting Federal income taxes. Last year, for example, pollster Lou Harris reported in testimony before the Senate Finance Committee that the public was displaying, in his polls, "anger" about the complexity and unfairness of the current system. He said the mood of revolt prevailed among many members of the taxpaying public.

Individual taxpayers and business people are deeply distressed about the burdens that the system of taxation imposes on them. I am not talking about the amount of tax that we Americans must pay; the level of taxation is a matter of political judgment that is best made by elected representatives in the Congress. They must set national priorities, decide on a budget that insures domestic tranquillity and security of the Nation, and otherwise meet the national needs of our society.

Rather, I am talking about the procedure by which the Federal Government collects taxes. That's what has people angry and disenchanted. The best, and most alarming, evidence of disenchantment is the growth of the so-called "underground" economy in which people do not report income or cheat on their deductions and exemptions. (Both tax dodges are unfortunately easy to do in the complicated system that we have today.) The IRS estimates that the total income of the underground economy is so large that, if it were taxed, it would generate more than $90 billion in Federal income taxes. Not only the loss of the tax revenue, but the increase in the illegal conduct of the taxpaying public, should be of concern to all of us.

While public pressure for action mounts, a second development can be seen in the tax reform field. This development began some years ago, when leading members of the tax field, including several distinguished former Commissioners of Internal Revenue, started to speak out about the need for tax simplification and reform. Among the early voices for reform were those of Mortimer Caplan, Donald Alexander, and Jerome Kurtz.

In 1982, these calls for tax reform took the shape of general and often ambiguous proposals. There was much talk about the merits of a "flat-rate" tax, although few in the media or elsewhere seemed to recognize that a flat-rate tax in itself is meaningless. A flat-rate tax can be understood only in terms of the tax base to which it is applied. Other people proposed reforms that seemed to be little more than a rehashing of the current system. Still others leaned toward the gimmick and quick-fix approach. Many "tax reform" bills were introduced in the House and the Senate.

Despite the obvious shortcomings of these proposals, something extremely important was happening in 1982: the Congress was beginning to take seriously the massive groundswell of public feeling about tax reform. Several important hearings were held, not the least of them exploratory hearings by the Joint Economic Committee and hearings on alternate tax systems by the Senate Finance Committee.

This year, the Congress has turned again to tax reform, now with a better understanding of the public desire for reform and a seemingly more sensible climate for reform. Gone are some of the more bizarre proposals of last year. In their place one sees, fortunately, serious and thoughtful proposals such as H.R. 3475, the Tax Simplification and Improvement Act of 1983, introduced by the chairman of the House Ways and Means Committee, Dan Rostenkowski of Illinois, and by the ranking minority member of the committee, Barber B. Conable, Jr., of New York.

Those of us who have spent years working on the issue of tax simplification and reform are understandably wary of what direction reform might take in this Congress and the next Congress. That does not deter me, however, from applauding the efforts of many Members of Congress to pursue tax reform and to welcome the proposal of Chairman Rostenkowski and Mr. Conable as a valuable approach to tax simplification and reform.

WHY REFORM IS NECESSARY

The problems with the current federal income tax lie deep within the very nature of the system. Today's system is a Net Income Tax—a NIT system. The heart of the NIT is a complicated formula that is highly subjective and works differently for virtually every taxpayer and business. By careful and judicious use of deductions, exemptions, and tax credits, one Individual Wage Earner (IWE) can pay comparatively low tax on a high income, while a differently situated IWE pays comparatively high tax on a much lower income.

Similarly, the tax burden falls unevenly and almost capriciously on businesses. By skillful use of accounting procedures, and by implementing an aggressive tax-reduction strategy, a Business Operating Entity [BOE] can substantially reduce its taxable income. Among its major tactics in this effort is the careful timing and direction of important business decisions, such as the purchase of new plant or equipment, the buildup or draw down of inventory, expansion or contraction of workforce, and so on. Unfortunately for both the individual company and the economy as a whole, these tax-driven decisions are not always the best business and economic decisions, as top managers and economists are the first to admit.

One consequence of the NIT system is that profitable, well managed BOEs wind up subsidizing unprofitable, poorly managed companies. This is true because only the profitable company pays taxes, thus helping to pay for national defense, social and economic programs, and other aspects of national government. The unprofitable company benefits from the activities of the national government, but does not pay for them.

One can illustrate the current situation with a hypothetical extreme: imagine that all companies in the nation merge into what are finally two gigantic conglomerates, the Wee Can Company and the Wee Cant Company. Wee Can is well run and turns a handsome profit each year. Wee Cant is badly run and operates in the red. Which company will pay taxes to the Federal Government? Wee Can, of course.

In summary, the NIT system is unfair, inequitable, and inefficient. It imposes the obligation to pay taxes unequally on different individuals and businesses. Furthermore, it is not neutral: it forces individuals and businesses to make decisions on the basis of tax consequences instead of sound economic considerations. The NIT system is not predictable; changes in tax law may or may not have the intended effect, depending in part on how the IRS regulations are written and in part on how accountants and tax lawyers are able to find ways of coping with the changes.

THE ROAD TO A SOLUTION

Because the problems with the current tax system are so profound, the answers must also be profound. There is nothing to be gained in tinkering with the NIT system, because the system itself is faulty. What is needed is a new approach, a fresh start in the way that this nation raises federal income taxes.

All of the inherent shortcomings of the NIT system can be eliminated by converting to a Gross Income Tax—GIT system. GIT is fair, efficient, and neutral. It spreads the tax burden evenly across society, generates revenue efficiently and predictably, and frees individuals and business to pursue strategies without concern for tax consequences.

GIT imposes a single rate of tax, probably a very low rate, on the Gross Income of every BOE. Gross Income consists of gross receipts less cost of inventory. A BOE would not be able to deduct cost of operations. Every BOE could pay tax regularly—even daily—on its Gross Income, and it would not have to worry about filling out tax forms, maintaining massive files of records, or hiring teams of accountants and lawyers to help it shape a tax strategy.

Most IWEs would not fill out or file a federal income tax return at all. Their employer would report their income to the IRS and the IRS would allocate to each IWE his or her share of federal income tax and FICA paid by the BOE and send a statement to the IWE showing how much federal income tax and FICA they had been credited with paying. So the IRS would file a tax statement with the taxpayer, instead of the other way around.

There would be no deductions or exemptions allowed, but none would be needed; the rate of taxation would be so low, probably between 4 and 5 percent, that pressure for special tax breaks would largely dissipate. The Congress could create incentives for certain kinds of activity by the use of tax credits below the line instead of tax deductions above the line.

The GIT Income tax return for a BOE would be a simple, one-page form showing the bare essentials of information (see illustration, next page.) The administrative work flow under GIT would be vastly simpler than it now is under NIT (see Figures A and B).

CONCLUSION

H.R. 3475 represents a laudable effort to reduce some of the complexities and inequities in the current federal income tax system. The Congress should enact this bill and it should enact other legislation designed to simplify and make more equitable the federal individual and corporation income tax laws.

Beyond that, the Congress should undertake fundamental reform of the system. It should convert the system to GIT.

This ID number would cover every taxpaying entity, whether a corporation, division of a corporation, a professional investor, or an individual operating as a free enterpriser

By paying an income tax on its gross income, a business operating entity (BOE) avoids the massive overhead costs associated with seeking deductions and other tax avoidance devices. Once a BOE files this return and pays the tax due, it can spend the remainder of its receipts any way it chooses. Thus, under GIT, businesses could operate freely on an economic basic rather than on a tax-consequent basis.

BUSINESS GROSS INCOME TAX RETURN

Name ____________ Type of Business Operating Entity (BOE) ______ ①
Address ____________ City ____________ State ______ Zip ______ ②
Taxpayer Number ____________ Period of Return: From ______ to ______ ③

Gross Receipts

Sale of Goods ____________ $____________ ④
Sale of Services ____________ ____________ ⑤
Sale of Combination of Goods and Services ____________ ____________ ⑥
Rentals of Real Estate ____________ ____________ ⑦
Sale of Real Estate ____________ ____________ ⑧
Rentals of Other Chattels ____________ ____________ ⑨
Dividends from Stocks ____________ ____________ ⑩
Sale of Stocks ____________ ____________ ⑪
Interest from Bonds ____________ ____________ ⑫
Sale of Bonds ____________ ____________ ⑬
Interest Received on Loans ____________ ____________ ⑭
Interest Received on Savings Accounts ____________ ____________ ⑮
Inheritances (market value) ____________ ____________ ⑯
Gifts (market value) ____________ ____________ ⑰
All other Income not reported above ____________ ____________ ⑱
Salaries or Wages (report only amounts received above $50,000.00) ____________ ____________ ⑲
Total Gross Receipts $____________ ⑳
Cost of Sales $____________ ㉑
Gross Income (Line 20 Less Line 21) $____________ ㉒
Gross Tax (5% Times Line 22) $____________ ㉓

Credits

Investment ____________ ____________ ㉔
Employment ____________ ____________ ㉕
Export Sales ____________ ____________ ㉖
Other Approved Credits ____________ ____________ ㉗
Total Credits $____________ ㉘
Total Tax (Line 23 Minus Line 28) $____________ ㉙

Total Wages Paid to Employees (IWE) for Year of Return $____________ ㉚
Total Number of Employees (IWE) ____________ ㉛

FOR IRS USE ONLY

Allocation for Employees Tax Contribution $____________ ㉜
Allocation for FICA $____________ ㉝
Allocation for Health Care $____________ ㉞
Allocation for General Revenue $____________ ㉟

Sufficient income from any of these sources would make an individual wage earner (IWE) a BOE for tax purposes

This consecutive 12-month period will vary from one BOE to another. By staggering BOE tax reporting and payment dates throughout the year, the GIT system would preserve the Government's cash flow while eliminating interest-free Government borrowing.

Under the GIT system income from inheritances and gifts would be taxed at the same rate as all other forms of income. There would be no additional tax burden, as there is under the present system

This line provides for those cases where an employee earns far in excess of what could be considered fair wages for ordinary manual or mental input. Any employee who earns more than $50,000 per year (or whatever limit Congress sets), and who is thus engaged in the "sale of expertise," would be considered a BOE.

This section may be used to promote any social or economic goals deemed advantageous for the Nation

Because GIT would vastly broaden the tax base, the actual rate of taxation required to generate sufficient revenue for the Government would be very low. It is estimated that the tax rate would be from 4½% to 7½%.

The information in this section would be used to determine employee allocations for Federal income tax, FICA, and any other funds designated by Congress. This information would be broken down by individual employee on a separate form, to account for partial years of employment, overtime, and raises. It is this second form that the IRS would use to allocate individual employee contributions. Once allocated, the IRS would then inform each employee of the amounts they paid into each fund

This section would:

1. Eliminate the need for making out billions of W-2 forms (and related support paperwork) by all BOE's (Business Operating Entities) in the country.
2. Eliminate millions of income tax returns by individuals each year.
3. Finance the Social Security Program out of the same funds from whence it now comes, but by a more direct and less costly route. These funds are the gross income which a BOE uses to pay his share and also the wages from which the IWE pays his share. It all comes from the same pot.
4. Give our Congress complete control and efficiency in operating any social system which must be separately funded.

The IRS would specify in this section the total allocation for all employees to each fund designated by Congress. The allocation percentages would be monitored closely by Congress and would be changed yearly, as needed

This illustrative GIT return when plotted on a mathmatical basis follows the form.

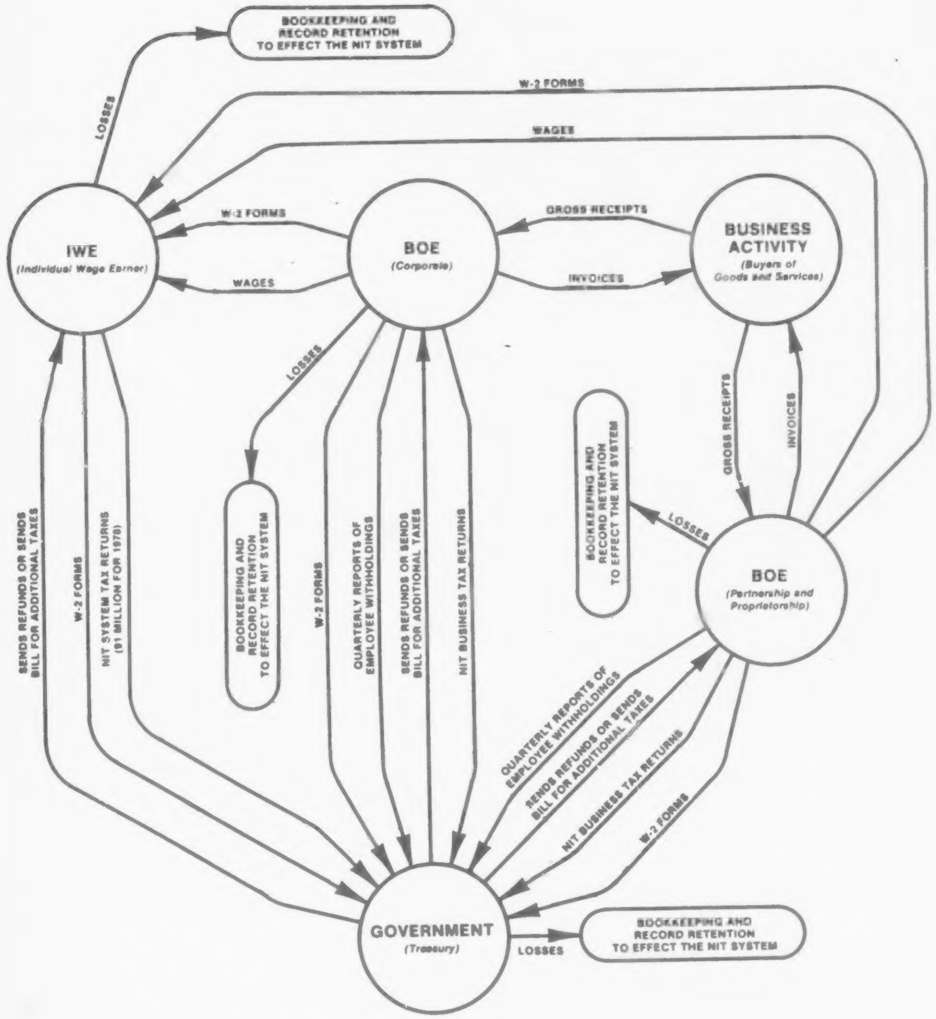
$$y = mx \pm b_1 \pm b_2 \pm \ldots b_n$$

where.

y = Revenue (Yield) (line 29)
m = Tax Rate (line 23)
x = Gross Income (line 22)
b_1, b_2 = Tax Expenditures (Credits) (lines 24 thru 27)

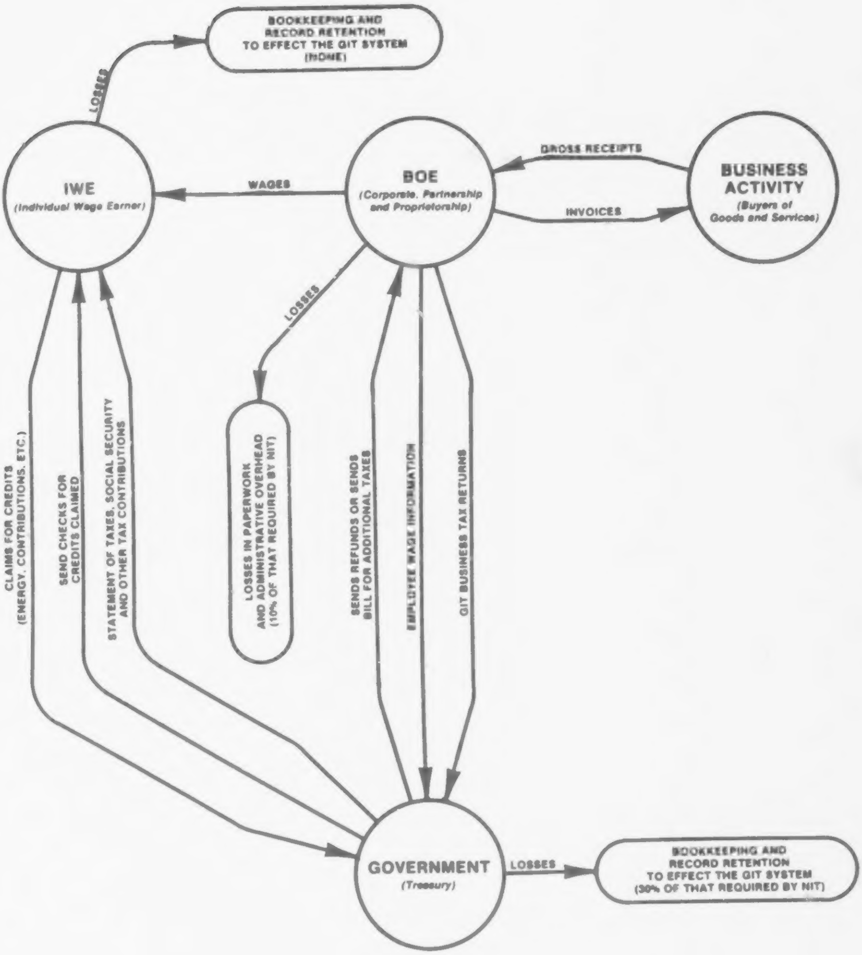
The major advantage of the GIT system is that this Straight Line (Flat Rate) formula can be easily computerized. Consequently the Internal Revenue Service could furnish the Congress and the Executive branch with fast printouts of the results of any changes made. With such immediacy of response remedial decisions could be made on an informed basis.

REVISED 7-1-82


BOOKKEEPING AND RECORD RETENTION TO EFFECT THE NIT SYSTEM
LOSSES
W-2 FORMS
WAGES
IWE
(Individual Wage Earner)
W-2 FORMS
WAGES
BOE
(Corporate)
GROSS RECEIPTS
INVOICES
BUSINESS ACTIVITY
(Buyers of Goods and Services)
LOSSES
BOOKKEEPING AND RECORD RETENTION TO EFFECT THE NIT SYSTEM
SENDS REFUNDS OR SENDS BILL FOR ADDITIONAL TAXES
W-2 FORMS
NIT SYSTEM TAX RETURNS (91 MILLION FOR 1978)
W-2 FORMS
QUARTERLY REPORTS OF EMPLOYEE WITHHOLDINGS
SENDS REFUNDS OR SENDS BILL FOR ADDITIONAL TAXES
NIT BUSINESS TAX RETURNS
BOOKKEEPING AND RECORD RETENTION TO EFFECT THE NIT SYSTEM
LOSSES
GROSS RECEIPTS
INVOICES
BOE
(Partnership and Proprietorship)
QUARTERLY REPORTS OF EMPLOYEE WITHHOLDINGS
SENDS REFUNDS OR SENDS BILL FOR ADDITIONAL TAXES
NIT BUSINESS TAX RETURNS
W-2 FORMS
GOVERNMENT
(Treasury)
LOSSES
BOOKKEEPING AND RECORD RETENTION TO EFFECT THE NIT SYSTEM

NIT SYSTEM
ADMINISTRATIVE WORK FLOW

Figure A


BOOKKEEPING AND RECORD RETENTION TO EFFECT THE GIT SYSTEM (NONE)
LOSSES
IWE
(Individual Wage Earner)
WAGES
BOE
(Corporate, Partnership and Proprietorship)
GROSS RECEIPTS
INVOICES
BUSINESS ACTIVITY
(Buyers of Goods and Services)
LOSSES
LOSSES IN PAPERWORK AND ADMINISTRATIVE OVERHEAD (10% OF THAT REQUIRED BY NIT)
CLAIMS FOR CREDITS (ENERGY, CONTRIBUTIONS, ETC.)
SEND CHECKS FOR CREDITS CLAIMED
STATEMENT OF TAXES, SOCIAL SECURITY AND OTHER TAX CONTRIBUTIONS
SENDS REFUNDS OR SENDS BILL FOR ADDITIONAL TAXES
EMPLOYEE WAGE INFORMATION
GIT BUSINESS TAX RETURNS
GOVERNMENT
(Treasury)
LOSSES
BOOKKEEPING AND RECORD RETENTION TO EFFECT THE GIT SYSTEM (30% OF THAT REQUIRED BY NIT)

GIT SYSTEM

ADMINISTRATIVE WORK FLOW

Figure B

Mr. **HANCE**. The next witness is Mr. Levinson.

Mr. **LEVINSON**. Thank you, Mr. Chairman.

Mr. **HANCE**. Mr. Levinson is vice president for taxes, Colt Industries, Inc.

STATEMENT OF JULES LEVINSON, VICE PRESIDENT, TAXES, COLT INDUSTRIES, INC., ACCOMPANIED BY GEORGE WEBSTER, COUNSEL

Mr. **LEVINSON**. Thank you.

I am Jules Levinson, vice president of taxes, Colt Industries, Inc. I am pleased to have the opportunity to be present today to speak in respect of section 504 to the Tax Law Simplification Improvement Act of 1983, H.R. 3475.

At the outset, I wish to express my thanks to Chairman Rostenkowski and Mr. Conable for enabling the introduction of the bill, and to the other members of the group for permitting me to come by and speak to the point.

We strongly urge the enactment of H.R. 3475 because we believe that it contains very important aspects to simplify a very complex statute under which tax practitioners have to operate. We are particularly concerned with this bill with respect to section 504 because of the effective date of the bill, and would respectfully request that the committee consider making the effective date of the amendments a date prior to the effective date of the bill.

Under the present law, because of the enactment of section 1248(f) in 1976, the earnings and profits of a controlled foreign corporation are subject to double taxation in the situation where a domestic corporation—the owner of the CFC—is liquidated by its domestic parent corporation and section 334(b)(2) prior to its repeal was applicable even though the CFC's organization and business is not in any way affected as the result of the liquidation of the domestic parent corporation.

This inequitable situation was brought about as a result of the extension of the scope of section 1248 of the Internal Revenue Code by the Tax Reform Act of 1976. Enactment of section 1248(f) provided for a new area of deemed dividend treatment in the case of CFC stockholdings distributed by liquidating domestic corporations. In the absence of corresponding provisions in the code specifically detailing the tax effects of subsequent distributions from the E&P deemed to have been a dividend under section 1248(f), such E&P is subject to taxation a second time.

Congress in the Tax Equity and Fiscal Responsibility Act of 1982—TEFRA—sought to remedy the inequity by eliminating the stock of CFC's from the deemed sale provisions of section 338(a) thus eliminating the section 1248 dividend treatment. However, transactions which took place from October 9, 1975, the effective date of section 1248(f) as enacted by the Tax Reform Act of 1976, until August 31, 1982, the effective date of section 338 as enacted by TEFRA, continued to have the inequitable treatment apply.

There is an interplay between section 1248(f) and Revenue Ruling 71-388 which says that even though you pay tax on the earnings and profits at the time of the liquidation, they are still deemed to be earnings and profits upon a subsequent distribution by the CFC to the shareholder corporation which previously paid tax on such earnings and profits at the time of liquidation.

It is because of that interplay and because the fact that this legislation seeks to remedy the inequity created by section 1248, that we are proposing that the amendment which has been introduced be modified. We are asking that the committee make the effective date of the bill so that those people adversely affected during that window period from 1975 to 1982 would have the impact ameliorated in respect of those adverse effects.

Accordingly, sir, we have requested that the effective date language be amended to provide the distribution of earnings or profits occurring on or after December 27, 1979, will have the beneficial remedial impact of this section.

Thank you for the opportunity to speak. In the event there are any questions, I will be pleased to answer them.

[The prepared statement follows:]

STATEMENT OF JULES LEVINSON, VICE PRESIDENT—TAXES, COLT INDUSTRIES, INC.

My name is Jules Levinson, I am Vice President-Taxes, Colt Industries, Inc., 430 Park Avenue, New York, N.Y. 10022.

Our interest in the bill lies in particular in section 504, amendments related to section 1248 of H.R. 3475.

While Colt strongly supports the concept behind section 504, Colt believes that the effective date provision of the section, to a large extent, vitiates the intent of the section and is inequitable.

Under present law, because of the enactment of section 1248(f) in 1976, the Earnings and Profits [E&P] of a controlled foreign corporation [CFC] are subject to double taxation in the situation where a domestic corporation (the owner of the CFC) is liquidated by its domestic parent corporation and section 334(b)(2) prior to its repeal was applicable even though the CFC's organization and business is not in any way affected as the result of the liquidation of the domestic parent corporation. This inequitable situation was brought about as a result of the extension of the scope of section 1248 of the Internal Revenue [IRC] by the Tax Reform Act of 1976. Enactment of section 1248(f) provided for a new area of deemed dividend treatment in the case of CFC stockholdings distributed by liquidating domestic corporations. In the absence of corresponding provisions in the Code specifically detailing the tax effects of subsequent distributions from the E&P deemed to have been a dividend under section 1248(f), such E&P is subject to taxation a second time. Congress in the Tax Equity and Fiscal Responsibility Act of 1982 [TEFRA] sought to remedy the inequity by eliminating the stock of CFC's from the deemed sale provisions of section 338(a) through eliminating the section 1248 dividend treatment. However, transactions which took place from October 9, 1975 until August 31, 1982 continue to have the inequitable treatment apply.

Under section 1248(f) (1) and (2), if a parent corporation liquidates a domestic subsidiary which holds the stock of a CFC and the parent corporation takes a "stepped-up basis" in the stock of the CFC pursuant to section 334(b)(2), the parent corporation is deemed to have received a dividend from the CFC to the extent that the fair market value of the stock of the CFC exceeds the liquidated subsidiary's former basis in such CFC stock. However, the Internal Revenue Service has taken the position in Rev. Rul. 71-388, 1971-2 C.B. 314, 315, that the amount treated as a dividend does not reduce the E&P of the CFC, as would normally be the case under section 312(a) of the Code. As a result, if the earnings and profits of the CFC, which have already been taxed as a deemed dividend under section 1248 are subsequently distributed to the parent corporation, these same earnings and profits would again be subject to tax as a dividend under sections 301(c)(1) and 316 of the Code.

Although the result achieved by section 1248(f) alone is a proper one, the failure to take its effects into account in the case of subsequent distributions of the E&P of a CFC creates an inequitable situation.

The effect of the present law is to tax E&P twice in the situation described. It is a deemed dividend at the time of the liquidation of the CFC into the parent corporation. This deemed dividend does not reduce the earnings and profits of the CFC when paid to the parent.

This situation is precisely what has occurred to Colt Industries in one of its transactions.

Colt seeks relief by the application of the provisisons of section 504 to distributions from and after December 27, 1979.

The reason for this is that under the effective date provisions of section 504 as currently drafted, distributions of E&P from CFC's, whose stock was acquired by a Liquidation to which section 334(b)(2) was applicable after October 9, 1975, will continue to be currently taxed even though such E&P was previously taxed because of section 1248(f). Since the inequity arises upon the actual distribution of the previously taxed E&P, Colt urges that section 504 be made applicable to all distributions taking place after December 27, 1979.

Colt respectfully requests that section 504(c) be modified to read as follows:

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to distributions of earnings and profits occurring on or after December 27, 1979.

I thank you for your kind attention.

Mr. HANCE. Mr. Hughes.

STATEMENT OF VESTER T. HUGHES, JR., ON BEHALF OF THE SOUTHWEST SMALL BUSINESS STUDY GROUP AND SAMMONS ENTERPRISES, INC., ACCOMPANIED BY RICHARD MASSMAN, DAVID GLICKMAN, AND DAVID SINAK, DALLAS, TEX.

Mr. HUGHES. Mr. Chairman, members of the committee, my name is Vester Hughes. I am pleased to have the opportunity to present the views of the Southwest Small Business Study Group and my client Sammons Enterprises Inc. on title III of H.R. 3475, dealing with the revision of the at risk rules.

I am accompanied by three other members of the Southwest Small Business Study Group—Mr. Richard Massman, Mr. David Glickman, and Mr. David Sinak, of Dallas, Tex.

Section 301 of the bill recognizes that closely held active businesses are unfairly treated under the present at-risk rules. Unfortunately, the bill only provides a partial solution. Section 301 of the bill addresses the passthrough of the investment tax credit to shareholders of S corporations where the shareholders individually are not at risk. The bill provides a solution by permitting ITC to passthrough in the case of S corporations engaged in active trades or businesses.

Similarly, regular closely held subchapter C corporations engaged in active businesses are unfairly discriminated against under the at-risk rules and relief can and should be provided to such subchapter C corporations similar to that which is provided under the bill for S corporations.

Briefly, such closely held C corporations have two or three principal problems under the present at-risk rules.

The first of these problems is that a parent and a subsidiary may very well not be able to use the subsidiary's losses even though the subsidiary is a substantial corporation, has existed for many years, and generally creates these losses only as a result of expanded operations.

The second problem is that a closely held corporation that is able to finance an expansion of its business by nonrecourse financing may not be able to offset the losses of such expansion, for instance, the losses generated by depreciation and interest costs such expansion creates, against the income from other lines of business.

Now, this puts such corporations at a competitive disadvantage with corporations similarly situated that just have a different number of shareholders and therefore are not subject to the at-risk rules.

This problem has been recognized for some time, and by various persons within the government. It was brought up last year toward the end of the session when TEFRA was being considered. And at that time it was determined that provisions changing and improving the situation should be delayed until the problem could be given further study. Such further study was indeed given, and I think it is fair to say that everyone who has looked at the problem realizes that there is a discriminatory effect on closely held businesses.

The use or nonuse of a loss should not be dependent upon whether a business has 5, 10, or 20 shareholders. Publicly held businesses that are in direct competition with closely held businesses have a distinct advantage, if the closely held business cannot compete against the publicly held business on the same tax basis.

Therefore, we have suggested a solution to this problem which we believe fits right in with what is contained in title III of the bill.

Title III demands that there be an active trade or business and that there be three employees, if the investment tax credit benefit is to be accorded an S corporation and passed on through to the shareholders.

What we have suggested is that, similarly, if an active business is involved, the parent should not be denied the losses of the subsidiary that incurs losses by reason of expanding its business or any other particular reason so long as an active business is indeed involved.

The second thing required is that the business be managed by the corporation—that is that the corporation manage the business rather than hire an independent contractor to do so. That is sort of a strange concept, but it is one not unknown, and we have taken the lead from what is already on the books and feel that the way the matter is set out in the Revenue Act of 1978 defining active management adequately covers this situation.

Third, we feel that any possible abuse is also dealt with by having a requirement of three active employees in addition to any other employees. This hedges against the possibility of the use of the provisions as a tax shelter. Certainly we do not want to increase the likelihood that the at-risk rules will in any way be watered down and not usable against any form of abusive tax shelter.

That is not what has happened here. What has happened here is that truly active going businesses are discriminated against, merely because they have fewer shareholders than the larger shareholding groups of similarly situated corporations.

We believe that we have come up with a solution that follows along the pattern for the investment tax credit and that the investment tax credit proposal does not go far enough to cover this related and similar problem. We believe that the proposal we are making does not open up abuse potential. We believe that it is clearly within the framework of the at-risk correction that the bill addresses in title III. Therefore, we would propose that this addition be made to correct at-risk limitations with respect to subchapter C corporations.

We have an extensive presentation that we would like to be filed in the record fully, and I would be happy to try to answer any questions related to our proposal.

[The prepared statement follows:]

STATEMENT OF VESTER T. HUGHES, JR., ESQ., ON BEHALF OF SOUTHWEST SMALL BUSINESS STUDY GROUP AND SAMMONS ENTERPRISES, INC.

Mr. Chairman and members of the committee: My name is Vester T. Hughes, Jr. I am pleased to have the opportunity to present the views of the Southwest Small Business Study Group and my client Sammons Enterprises, Inc. on title III of H.R. 3475, dealing with the revision of the at risk rules. The Southwest Small Business Study Group is a group of tax professionals in Dallas, Tex., whose members represent a broad spectrum of closely held corporations that are adversely affected by the present at risk rules. Sammons Enterprises, Inc. is a closely held corporation with executive offices in Dallas, Tex. that is engaged in several lines of business.

OVERVIEW

Closely held corporations engaged in active trades or businesses should be free to compete on the same basis as widely held corporations. The present at risk rules impose artificial barriers on this competition (1) by disrupting the flow-through of losses within a consolidated group of corporations even where only full recourse financing is involved and (2) by impeding the ability of closely held corporations to expand their capital base through legitimate non-recourse financing. Title III of H.R. 3475 recognizes that these types of problems exist, but provides a solution only with respect to the flow-through of the investment tax credit from an S corporation (as defined in section 1361(a)(1) of the Internal Revenue Code of 1954, as amended ("Code")) to its individual shareholders. At the same time that the plight of individual shareholders of S corporations is resolved, similar problems encountered by closely held corporations should be addressed, especially since these problems may be corrected through the use of legislative principles similar to those utilized in section 301(a) of H.R. 3475 and within the general precepts of those proposals.

The problems of closely held corporations caused by the present at risk rules under Code sections 465 and 46 that are part of the same or similar problems resolved for S corporations by H.R. 3475 are the following (a corporation is considered closely held if more than 50 percent of its stock is owned by five or fewer shareholders):

a. *Consolidated tax return problems.*—Losses generated by a corporate subsidiary are not available to offset the income of a closely held parent, except to the extent that the parent has "basis" in the stock of the subsidiary. Temporary Treasury Regulation ("Temp. Reg.") § 5.1502-45. It is quite common for the parent to have no basis in the subsidiary, especially where the subsidiary has been in existence for some time and has a substantial net worth in its own right. This detriment applies to the closely held parent corporation even though (i) all debt at the subsidiary level is on a full recourse basis or (ii) the subsidiary has no debt whatsoever.

b. *Use of nonrecourse debt.*—A closely held corporation that conducts several lines of business is not able to utilize losses of one line of business to offset the income of another line of business in situations in which the business generating losses utilizes significant nonrecourse financing. Closely held corporations, like their more widely held counterparts, make use of nonrecourse debt from third-parties to expand and protect their "borrowing base" under long-term credit agreements with banks or other financial institutions.

c. *Seller financing.*—The investment tax credit is denied to a closely held corporation with respect to equipment purchased with seller nonrecourse financing.

d. *Twenty percent investment requirement.*—The investment tax credit is denied to a closely held corporation with respect to the purchase of equipment utilizing nonrecourse financing from a third party (nonseller) if the corporation does not have at least a 20 percent at-risk investment in the equipment. None of the foregoing rules apply to publicly held corporations.

Generally, these problems should be addressed by excluding from the scope of the at risk rules the "activities" of closely held corporations that constitute active trades or businesses, in which the taxpayer actively participates in management, and with respect to which there are engaged at least three full-time, nonowner employees. This test is essentially the same as the test contained in the proposed amendment to Code Section 46(c)(8)(E) provided by section 301(a) of H.R. 3475.

BACKGROUND

The Tax Reform Act of 1976 enacted many provisions designed to combat tax shelter transactions. Among these provisions were the so-called "at risk" rules contained in Code Section 465. Originally, these at risk rules applied only to four specific activities: (1) farming; (2) exploring for, or exploiting, oil and natural gas resources; (3) holding, producing, or distributing motion picture films or video tapes; and (4) leasing of personal property. As originally enacted, these "specific" at risk rules applied only to individuals, S Corporations, and personal holding companies.

Under the at risk rules, a taxpayer's loss for any taxable year from covered activities was limited to the amount the taxpayer had "at risk" and could actually lose from the activity. Initially, the amount at risk is generally the sum of (1) the taxpayer's cash contributions to the activity, (2) the adjusted basis of other property contributed to the activity, and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability for repayment.

In 1978, Congress continued to be concerned that certain undesirable tax-sheltering activity was outside of the scope of the then existing at risk rules. Accordingly, the Revenue Act of 1978 expanded the at risk rules to apply to investments (direct or indirect) in all activities except real estate. Further, the class of taxpayers subject to the at risk rules was expanded to include all corporations more than 50 percent of the stock of which is held by five or fewer individuals (herein referred to as "closely held corporations"). The purpose of this expansion was explained in the report of the Committee on Ways and Means as follows: "Other closely held corporations can continue to use tax shelter deductions to avoid the accumulated earnings tax or to shelter income on which owner-employees would otherwise pay tax at the individual level. To eliminate this type of income sheltering by corporations, the committee believes that the at risk rules should be extended to closely held corporations." H. Rept. No. 95-1445, 95th Cong., 2d. Sess. 68 (1978). However, in expanding the scope of the at risk rules to include closely held corporations, an exception was created for closely held corporations that are "actively engaged" in leasing tangible equipment. Code section 465(c)(4).

The Economic Recovery Tax Act of 1981 [ERTA] further extended the a risk rules by providing that in the case of property used in a activity to which the loss limitation rules of Code section 465 apply, the investment tax credit available with respect to such property will be limited under Code section 46(c)(8) based upon the amount which the taxpayer has at risk in the property. The general at risk rules of Code section 465(b) apply for investment tax credit purposes, except that under the at risk rules as applied to the investment tax credit, there is an exception in the case of nonrecourse financing obtained from certain lenders provided that the taxpayer has at least 20 percent of the cost at risk in the equipment. Code section 46(c)(8)(B).

In 1982, during the consideration of the Tax Equity and Fiscal Responsibility Act of 1982 [TEFRA], the problems addressed above, including the S corporation problem directly addressed in H.R. 3475, were recognized as needing resolution, but time pressures prevented action. However, in addition to the over-valuation penalties previously added by ERTA, new penalty measures were included in TEFRA that affect the same tax shelter activities the at risk rules are designed to curb (including penalties for substantial understatements of tax liability, promoting abusive tax shelters, and aiding and abetting substantial understatements; see general TEFRA, title III, subtitle C). The presence of these measures in the Code emphasizes that the very real need to find a solution to the at risk problems of nontax shelter active businesses can be fulfilled with virtually no chance that the solution applied will give rise to abusive tax shelter opportunities.

Since 1982, the at risk problems have been considered further and it now is clearly appropriate that this legislation resolve them. While H.R. 3475 resolves part of the at risk problems that have been discussed and studied as a group, it does not resolve all the problems in that group. Specifically, the at risk problems of close held corporations discussed herein are not addressed in the bill.

PROBLEMS CREATED FOR CERTAIN CLOSELY HELD CORPORATIONS

The at risk rules were introduced into the law in order to thward abusive tax-sheltering activities by individuals. These at risk rules were extended to certain closely-held corporations primarily on the theory that such corporations were the alter-ego of their individual owners and could serve as vehicles for abusive tax-sheltering activity just as easily as if by the individuals themselves. Unfortunately, there has been caught within the broad scope of these rules a large number of privately held business corporations which, although owned by a small number of individuals, are operating business organizations (both small and large) that must compete in business and capital markets with competitors of similar size but whose stockholdings are sufficiently wide-spread to exempt them from the at risk rules. Small, medium, and large closely held corporations conducting active trades or businesses, the type that the Economic Recovery Tax Act of 1981 was designed to encourage, find themselves subjected to an onerous set of rules having no valid tax policy application to the type to business being conducted. It is submitted that the at risk rules impose unnecessary, and probably unintended, penalties on these closely held corporations in a number of areas of legitimate business endeavor. The following examples will illustrate this problem.

(a) Nonrecourse borrowings.—Many, if not most, closely held corporations, like their nonclosely held counterparts, finance a significant portion of their business activities through long-term credit agreements with banks or other financial institutions. Generally, these long-term credit agreements are with full recourse to the borrower. Additionally, the loan agreements governing such credit arrangements typically limit additional borrowings by the corporation to ceilings imposed by a debt-to-asset ratio test or other similar financial ratio test. Such loan agreements, however, usually permit the corporate borrower to obtain additional nonrecourse financing without regard to these tests. Thus, in commercial finance circles the use of nonrecourse financing is widely recognized as a method for expanding a corporation's borrowing base. This is particularly true since many lenders recognize the inherent and stable value of many items of capital equipment and are willing to make loans to well-managed corporations on a nonrecourse basis where capital equipment is pledged as collateral.

Certainly, the use of nonrecourse debt by a corporation to expand its borrowing base is not synonymous with "tax shelter." However, a closely held corporation may be prohibited from using these financial techniques because of the at risk rules. With respect to equipment acquired using nonrecourse debt, the corporation may be denied the investment tax credit unless it meets certain tests specified in Code secion 46. Under section 46(c)(8)(B), an investment tax credit in connection with seller financing on a nonrecourse basis to a closely held corporation is absolutely prohibited, and other nonrecourse financing with third parties will result in a denial of the investment tax credit unless the closely held corporation makes at least a 20 percent at-risk investment in the property. Neither of these limitations is imposed on corporations whose shares are more widely held. With respect to losses generated from activities financed by nonrecourse debt, the 20 percent at-risk exception is not even available. Thus, a corporation financing new captial equipment with nonrecourse indebtedness may find that it is unable to utilize the rapid depreciation afforded by the newly enacted "accelerated cost recovery system." This can be particularly critical in situations in which a corporation acquires equipment for use in a new area of business activity, since the at risk rules are applied on an "activity-by-activity" basis.

(b) Business operations through subsidiaries.—The use of subsidiaries in structuring corporate business operations is a well-known and elementary technique. The use of subsidiaries facilitates the division of management responsibilities and is important in isolating business risks associated with different areas of business activity. However, the at risk rules impose substantial limitations on the ability of closely held corporations to make use of these prudent management techniques. Consider the typical case of a closely held corporation with a proven business track record, which decides to expand into a new area of business activity and organizes a newly formed subsidiary for this purpose. The new business activity is capital intensive. The parent contributes certain used equipment to the subsidiary that has low tax basis but significant value, and the subsidiary arranges for financing of the remaining required capital equipment on a full recourse basis to the subsidiary. As expected, the subsidiary incurs net operating losses during the initial years until it captures a sufficient share of the market in which it competes. Even though the subsidiary will be conducting an active trade or business with a substantial number of employees, and even though all of the subsidiary's borrowings are on a "full recourse" basis, Temp. Reg. § 5.1502-45 provides that the corporate parent, because it is a closely held corporation, may not include losses of the subsidiary in its consolidated income tax return except to the extent that the parent corporation is at risk in the subsidiary's activities. The parent is treated as being at risk in the subsidiary's activities only to the extent that the parent guarantees the debt of the subsidiary (even though the lender may not require such a guaranty) or to the extent that the parent corporation has tax basis in the stock of the subsidiary. But the equip-

ment contributed by the parent gives it tax basis in that stock only to the extent of the low tax basis of the equipment. Thus the parent cannot utilize the subsidiary's losses in the consolidated return. Notwithstanding this fact, such losses will generate an excess loss account in the stock of the subsidiary which may generate income to the parent in the future. See Treasury Regulation sections 1.1502-32(b)(2)(i), 1.1502-32(e)(2), and 1.1502-19.

It should be pointed out that this surprising result is not limited to the case of a newly formed subsidiary, but can have application in the case of an old subsidiary with valuable assets that expands its business by acquiring new capital equipment through full-recourse loans.[1] It is submitted that application of the at risk rules in these cases places closely held corporations at a disadvantage in competing with corporations whose shares are more widely held and, further, runs counter to the capital formation incentives intended by Congress in enacting the Economic Recovery Tax Act of 1981. For a further exposition of the problems created by the Treasury's extension, through Temporary Regulations, of the at risk rules to consolidated groups of closely held corporations, see Blanchard, "Application of the 'At Risk' Rules to Consolidated Groups," 36 Tax Lawyer 661 (Spring 1983).

(c) Other examples.—There is attached as Annex 1 a number of specific examples illustrating the general adverse impact of the at risk rules described above.

PROPOSED SOLUTION

The at risk problems encountered by closely held corporations should be solved by provisions similar to those contained in section 301(a) of H.R. 3475 to provide relief from the at risk rules for certain S corporations. It is proposed that such provisions should exempt from the at risk rules only certain "activities" of closely held corporations in much the same manner as equipment leasing activities are presently exempted. Code section 465 currently applies the at risk rules on an activity-by-activity basis, and under the proposal presented hereby, an activity of a closely held corporation would be exempt from the at risk rules if it meets the following three tests:

A. The "activity" must constitute a trade or business. This requirement is patterned after present Code section 465(c)(3)(B) and (c)(4) regarding the aggregation of certain activities and the exclusion of certain equipment leasing corporations from coverage of the at risk rules.

B. The taxpayer must actively participate in the management of the trade or business. Again, this requirement has precedent in the provisions of Code section 465(c)(3)(B) regarding the aggregation of certain activities. The Joint Committee on Taxation explained this type of requirement in connection with the Revenue Act of 1978 as follows: "The determination of whether a person actively participates in the operation or management of a trade or business depends upon the facts and circumstances. Factors which tend to indicate active participation include participating in the decisions involving the operation or management of the trade or business, actually performing services for the trade or business, or hiring and discharging the employees (as compared to only the person who is the manager of the trade or business). Factors which tend to indicate a lack of active participation include lack of involvement in management and operation of the trade or business, having authority only to discharge the manager of the trade or business, or having a manager of the trade or business who is an independent contractor rather than an employee." General Explanation of the Revenue Act of 1978, 131 (Joint Committee Print 1979). We envision that an identical standard would apply in the case of our proposal.

C. Finally, there must be at least three full-time employees (other than owner employees) engaged in the activity. This requirement is patterned after the exclusion for leasing corporations contained in Code section 465(c)(4), except that it requires that the employee counted toward satsifying the three employees requirement own no stock of the corporation, whereas the exception for leasing corporations counts even owner employees.

Under our proposal, passive tax-shelter activities of a closely held corporation financed with nonrecourse debt would continue to be subject to the at risk rules. For purposes of applying the exclusion, a controlled group of corporations filing consolidated tax returns would be treated as a single entity for purposes of determining which of its activities are eligible for exclusion. In addition, activities conducted by a closely held corporation through a partnership would also be eligible for exemption from the at risk rules provided that all three tests described above are satisfied. It is intended that in the case of a partnership with more than one closely held corporate participant, there be at least three full-time, nonowner employees with respect to each corporation (i.e., if five closely held corporations form a partnership to conduct a trade or business, there must be 15, full-time, nonowner employees). In addition, specifically excluded from the exemption would be activities involving the use or exploitation of master sound recordings, motion picture films, video tapes, or tangible or intangible assets associated with literary, artistic, musical, or similar properties (except for exploitation associated with the operation of a radio or television station or cable television system).

---

[1] H.R. 3475 corrects the exactly comparable situation in the case of an S corporation by providing relief if either the corporation or the shareholder is liable. But the exception does not cover a C corporation (as defined in Code section 136(a)(2)) and hence would not alter the rule imposed by the temporary regulations.

Language embodying the proposal submitted hereby for exempting from the at risk rules certain activities of closely held corporations is set forth in H.R. 883, introduced by Congressman Pickle on January 25, 1983.

COMPARISON TO H.R. 3475

Section 301(a) of H.R. 3475 contains certain revisions of the at risk rules in the investment tax credit area. Our proposal addresses another related aspect of the at risk problem in the deduction and loss context as applied to closely held corporations, and does so by adopting a legislative approach that is quite similar to that containted in H.R. 3475.

The primary problem addressed in H.R. 3475 concerns the availability of the investment tax credit to the shareholders of S corporations, where the S corporation finances equipment with recourse debt but the shareholders of the S corporation are not personally liable on the debt. H.R. 3475 makes it clear that the "at risk" test is to be applied at the shareholder level, but provides that a shareholder shall be "deemed" to be liable for his share of recourse financing (determined at the corporate level) if such financing is provided in connection with property used by the corporation in an active trade or business and there are at least three full-time employees substantially all of the services of whom are directly related to such trade or business.

H.R. 3475 recognizes that the at risk rules should not restrict the availability of the investment tax credit to shareholders of an S corporation in circumstances where the corporation itself is at risk and the corporation is engaged in an active trade or business. Under H.R. 3475, there is no requirement that the shareholders have to be at risk in the activity in any way. Thus, the problem addressed is quite similar to the situation of a closely held parent corporation whose subsidiary is at risk in an activity but who is denied the use of losses of the subsidiary because the parent does not have tax basis in the subsidiary's stock.

The relief for S corporations under H.R. 3475 requires that there be recourse debt at at least one level. Such a requirement is appropriate in the case of an S corporation, since the relief granted permits tax benefits to flow through to "individual" taxpayers. However, such a requirement would be misplaced in the case of closely held corporations, generally. Although we have encountered many situations in which temporary regulation § 5.1502-45 unfairly limits a parent's use of losses even though the subsidiary (i) has substantial assets of its own and borrows on a full recourse basis or (ii) conducts activities without any borrowings whatsoever, it is unfair to closely held corporations to restrict them from utilizing nonrecourse financing on the same basis as more widely held corporations. As described above, the use of nonrecourse financing is widely recognized as a method of expanding a corporation's borrowing base. Under Code section 465, a closely held corporation that uses nonrecourse financing to any significant extent will find that its losses from the financed activities may be disallowed. In addition, the corporation may be denied the investment tax credit with respect to equipment financed through nonrecourse borrowings if it uses seller nonrecourse financing or, in the case of third-party financing, it is not at risk to the extent of 20 percent of the equipment cost. Nonrecourse financing for capital purchases is widely available, and there are no valid reasons for forcing closely held corporations to forego the use of this type of credit. Unlike section 301(a) of H.R. 3475, which permits tax benefits to flow through to "individual" taxpayers, the proposal submitted herein would permit the use of tax benefits only at the corporate level. Accordingly, since valid business reasons exist for the use of nonrecourse financing at the corporate level, a less restrictive rule should be applied than in cases where losses are flowed through to individuals.

The safeguards contained in our proposal to prevent improper exemption from the at risk rules are similar to those adopted in H.R. 3475 in determining whether it is permissible for "individual" taxpayers to avail themselves of investment tax credit in circumstances where they are not at risk:

(1) Like H.R. 3475, the proposal requires the existence of an active trade or business. In addition, it requires that the corporation itself actively participate in the management of such trade or business.

(2) Our proposal also requires that there be at least three full-time employees, substantially all the services of whom are services directly related to the trade or business. The proposal goes further than H.R. 3475 by also requiring that such three employees be nonowners of the corporation involved. This test further insulates the exemption from potential misuse by professional corporations.

Of course we support the at risk provisions of H.R. 3475. However, the at risk area requires further action. H.R. 3475 represents a partial solution to the at risk problems of active businesses. While this solution is good as far as it goes, there is no valid reason not to solve similar problems, or the same problem in a different context, at the same time. The at risk problems of both S corporations and C corporations which are closely held should be solved at the same time.

THE PROPOSED EXEMPTION WILL NOT OPEN THE DOOR TO ABUSIVE TAX SHELTERS

We believe that the three full-time, nonowner employee rule of our proposal serves as an absolute bar to the marketing of passive tax shelter investments to closely held corporations of the type that have been labeled "abusive" in the past, and thus would preserve congressional objectives in extending the at risk rules in 1978. In our experience, high income individuals are attracted to tax shelter investments only where they are primarily passive in nature. It is difficult to conceive of a taxpayer desiring to add three full-time employees to its payroll solely for the purpose of generating a tax break from an inherently noneconomic enterprise. Additionally, most professional tax advisers are of the view of that, at least in the case of professional corporations, sheltering income at the corporate level, rather than at the individual level, is terribly inefficient. So as a practical matter, abuse potential has been eliminated.

OTHER SOLUTIONS TO THE PROBLEM

We are cognizant that there may be more than one solution to the problems addressed herein. We believe that the best solution is one which completely exempts "active" business activities from the at risk rules, rather than an approach which continues to include activities within the scope of the rules but provides relief through expanded aggregation of activities or expanded use of a "deemed" at risk approach. The reason for this preference is a practical one: the latter alternatives would subject closely held corporations to what might be termed "unnatural" accounting obligations in order to demonstrate that they are in compliance with the rules. For corporations engaged in a number of lines of business, these accounting obligations can impose a substantial hardship.

However, the disadvantages currently being experienced by closely held corporations are so onerous that virtually any method for providing relief is a substantial improvement over the status quo. Thus we would be happy to work with the committee and the staffs to effect an appropriate solution to the problems. Whatever the solution, we think it very important that every effort be made to address the problems at the present time.

CONCLUSION

It is submitted that similarly situated taxpayers should be treated the same. The statement of Chairman Rostenkowski in introducing H.R. 3475 stated that such was one of the purposes of the bill; 129 Congressional Record H4880 (June 30, 1983). Closely held corporations engaged in active businesses that compete with public or nonclosely held corporations should not be subject to a set of rules aimed primarily at professional corporations and other incorporated wage earners. The focus of tax policy should not be on whether a corporation is closely held or publicly held, but rather should be on whether the activity in question lends itself to tax shelter abuse. As discussed above, there are legitimate, nontax reasons for corporations desiring to utilize nonrecourse debt or desiring to operate through the use of corporate subsidiaries. So long as public or other nonclosely held corporations are able to make use of such financing and business techniques, such financing and business techniques should not be denied to legitimate business corporations that happen to be closely held, particularly if such corporations can run the gauntlet of the tests such as those contained in the proposal submitted herein.

The plight of closely held corporations under the at risk rules was discussed extensively with Members of Congress, the Treasury Department, and their respective staffs during the course of consideration of the Tax Equity and Fiscal Responsibility Act of 1982. Although these problems were treated with sympathy, the time pressures of TEFRA simply did not permit adequate study of the issues by the tax writing committees and the Treasury Department. Accordingly, decisions were made to defer consideration of these issues pending further study. It is our understanding that this further study has clearly resulted in confirming that the issue is not whether, but how these problems should be resolved. Thus, we believe that all of the significant problems arising under the at-risk provisions should be addressed in the context of H.R. 3475, and not just the problems of S corporations. In order to permit closely held corporations to compete on an equal basis with more widely held corporations, the provisions of our proposal, as embodied in H.R. 883, together with any appropriate modifications, should be added to H.R. 3475.

We would be happy to answer your questions.

For the Southwest Small Business Study Group:

Vester T. Hughes, Jr., David L. Sinak, Cynthia M. Ohlenforst, Hughes & Hill, 1000 Mercantile Dallas Building, Dallas, Tex. 75201 (214) 760-5500.

Donovan Campbell, Jr., Rain Harrell Emery Young & Doke, Republic National Bank Tower, Dallas, Tex. 75201 (214) 742-1021.

Richard A. Massman, David G. Glickman, Jerred G. Blanchard, Jr., Johnson & Swanson, 4700 InterFirst II, Dallas, Tex. 75270 (214) 653-2000.

J. Dale Dawson, Peat Marwick Mitchell & Co., Suite 1400, Thanksgiving Tower, 1601 Elm Street, Dallas, Tex. 75201 (214) 747-8911.

ANNEX I

EXAMPLES OF IMPACT OF "AT-RISK" RULES ON CLOSELY HELD CORPORATIONS

The statement of the Southwest Small Business Study Group described, in general terms, the unfair penalties that are imposed on closely held corporations engaged in active businesses as a result of the at risk rules under section 465 of the Code that were designed to combat abusive tax sheltering transactions, primarily by individuals. This memorandum is intended as a supplement to that statement and provides graphic examples of the impact of these penalties on a closely held corporation.

EXAMPLE (1) EXISTING CORPORATION UNDERTAKING A NEW BUSINESS ACTIVITY

Facts of example

For over twenty years a closely held corporation ("the Company") has operated a very successful business involving the manufacture and installation of a special roofing material. The Company has generated significant taxable income during each year of its operation. The Company now desires to enter into a new field involving the manufacture and sale of various types of paint for both industrial and home use. The Company decides to operate this new business activity as a separate division within the Company.

In order to commence manufacturing paint, the Company must acquire $1,000,000 worth of new machinery. Because of the current slump in new machine-tool orders and sales and the huge inventory backlog of suppliers of such equipment, the Company is able to purchase the machinery on very beneficial terms: 15 percent (or $150,000) cash down-payment and the balance of 85 percent ($850,000) by means of nonrecourse seller financing secured by a mortgage on the new machinery.

Because of high start-up costs, including aggressive advertising and marketing expenses, and because its product is a new brand on the market, the Company expects to incur significant tax losses from the initial operation of its paint division.

Analysis of impact of at-risk rules

The roofing division continues to generate substantial taxable income. However, because the paint business would be considered a separate trade or business under the at risk rules, the Company may not aggregate the two businesses and offset the paint division tax losses against the roofing division taxable income, except to the extent the Company is at risk in its paint business. Instead, the Company must continue to pay tax on its roofing income, and must defer a significant portion of the tax losses from its paint business (the economic impact of such a deferral is analyzed in Example (2) below). Moreover, the Company would lose 85 percent of the investment tax credit on its new paint equipment under new section 46(c)(8) which extends the at risk rules to investment tax credit.

Obviously, these results put the Company at a competitive disadvantage when compared to the nonclosely held corporation that could (a) offset its roofing income against its paint losses and (b) enjoy without limit an additional $85,000 investment tax credit. Therefore, in contrast to a closely held corporation, a similarly situated, nonclosely held corporation would have significant additional funds available (from saved taxes) to expand its new paint business more rapidly.

EXAMPLE (2) USE OF A NEWLY FORMED SUBSIDIARY TO UNDERTAKE A NEW BUSINESS

Facts of example

A closely held corporation which employs more than 300 employees has been in business for more than 25 years. Its activities would meet anyone's standards of an "actively managed trade or business." The corporation desires to enter into a new capital intensive, service business. The new business, which will employ approximately 40 persons, requires a capital equipment investment of $6,202,000 of which $1,240,000 (20 percent) will be made as a cash contribution by the corporation. The remainder of the acquisition cost ($4,962,000) will be financed on a full recourse basis over 15 years at a rate of interest of 15 percent per annum. Because of risk of exposure to tort-type liability inherent in the service nature of the business, business prudence dictates that the corporation conduct the new service business through a newly formed, wholly owned subsidiary.

Analysis of Impact of at risk rules

Exhibit A attached to this memorandum presents an economic projection of the results of the subsidiary's activities, as well as an analysis of the impact on the closely held corporation (and its controlled group) of the at risk rules. This projection reflects that under the at risk rules, the parent's rate of return on investment in the subsidiary will be only 9.75 percent per annum (which is below the parent's typical threshold for making investments) whereas, under the rules applicable to nonclosely held corporations, the after tax rate of return would be 39.81 percent per annum. Because of this significant difference in rate of return, the closely held corporation is faced with the following painful choices, none of which is applicable to a similarly situated, nonclosely held corporation:

(1) Because of the possible exposure to tort liabilities, the corporation can use a subsidiary as the vehicle to conduct the business, even through the anticipated rate of return will be below the corporation's threshold investment level. Ultimately, this will pace the closely held corporation at a competitive disadvantage in that it will not be able to offer the same price concessions that a nonclosely held corporation may be able to offer because the nonclosely held corporation will have a greater "cushion" in the profitability of its investment.

(2) The corporation can ignore the exposure to tort liability and conduct the new service business as a new division of the corporation, rather than as a separately incorporated subsidiary. This choice exposes the closely held corporation to server potential business risks that are not faced by its nonclosely held competitors.

(3) The corporation can conduct the new service business through a new subsidiary, but have the parent corporation guarantee the debt of the subsidiary. Such a guarantee would increase the parent corporation's amount at risk in the subsidiary and permit the utilization of the start-up losses in a consolidated return. (Temporary Treasury regulation section 5.1502–45(b)(2)). However, this choice could severely impair the parent's borrowing base under many typical loan agreements, which require the parent to include as debt in computing its "debt to asset" ratio the amount of any indebtedness guaranteed by the parent, but exclude from the same computation the assets of a subsidiary which are pledged as collateral for the debt. The guarantee would be given even though the lender has not requested it and is willing to lend solely based upon the credit of the subsidiary and a pledge of the equipment as collateral.

In addition to the foregoing painful choices, it should be mentioned that under no circumstances could the subsidiary of the closely held corporation obtain financing for the new equipment from the manufacturer or seller of the equipment without losing a substantial part of the investment tax credit. This is another disadvantage that is not faced by the nonclosely held corporation.

EXAMPLE (3) EXPANSION OF BUSINESS BY AN EXISTING SUBSIDIARY

Facts of example

P, a corporation more than 50 percent of whose work is owned by five or fewer individuals, employs more than 50 individuals and has engaged in the retail business for 20 years. In 1972, P acquired 100 percent of the stock of S, a corporation employing more than 10 individuals and engaged in manufacturing activities, for $50,000. From 1972 through 1981, P and S filed separate Federal income tax returns. Both P's and S's activities clearly constitute actively managed trades or businesses. In 1982, the fair market value of S's net assets is equal to $2,500,000 but P's tax basis in the S stock is still only $50,000. P is not required to guarantee any of S's indebtedness.

In 1982, P and S decide to significantly expand S's manufacturing activities. To this end, S purchases additional manufacturing equipment for $1,000,000, using internally generated funds. Because of the additional expenses related to the start-up of the expanded activities and the ACRS deductions related to the new equipment, S suffers a tax loss in 1982 of $300,000. P incurs taxable income of $500,000 and elects to file a consolidated Federal income tax with S for 1982.

Analysis of impact of at-risk rules

Under temporary Treasury regulations section 5.1052-45, S's tax loss of $300,000 is includible in the computation of consolidated taxable income only to the extent that it does not exceed $50,000, the amount that P is at risk in the activities of S at the close of 1982. P's amount at risk in the activities of S is limited by its tax basis in the stock. Under the same rules applicable to nonclosely held corporations, all of S's $300,000 tax loss could be included in the computation of consolidated taxable income in 1982.

Despite the limitation on S's tax loss, P must establish an excess loss account with respect to its S stock of $250,000, by operation of the annual investment adjustments under regulation section 1.1502-32 and 1.1502-19.

EXAMPLE (4) PURCHASE OF PARENT AND SUBSIDIARY CORPORATIONS

Facts of example

Parent Cable Corporation ("P") owns several cable T.V. franchises and each of P's wholly owned subsidiaries owns a cable T.V. franchise (S-1 owns a franchise in State 1; S-2 owns a franchise in State 2, etc.). Buyer ("B"), a closely held corporation, buys P for $50 million, so B's basis in P is $50 million. P's basis in S-1 is $1 million. S-1, which has been operating as an active business for several years, and which has a fair market value of $25 million, unexpectedly loses $5 million in 1982. S-1 is fully at risk in its cable T.V. business.

Analysis of impact of at-risk rules

The identity of B determines the tax liability of P and its subsidiaries. If B is subject to the risk rules, S-1's losses can be included in the consolidated return filed by P and its subsidiaries only to the extent that P is at risk in S-1 ($1 million) (Temporary Treasury Regulation Section 5.1502-45(a)(3)) notwithstanding the fact that S-1's amount at risk exceeds $5 million. Therefore, $4 million of S-1's losses will not be includable in the computation of consolidated taxable income. However, if P had been purchased by a corporation owned by several shareholders, no five or fewer of whom own more than 50 percent of P, S-1's losses would be includable in the consolidated taxable income. Thus P—which must compete in the marketplace with other cable T.V. companies—will pay higher taxes than a similarly situated company that is identical in all respects to P except that its stock is held by a larger group of shareholders.

CONCLUSION

The Study Group's statement and these examples illustrate that there is no valid tax policy reason for forcing upon a closely held corporation the competitive disadvantages described above. H.R. 883 would permit closely held corporations to compete on the same basis as nonclosely held corporations with respect to activities that meet three tests:

(1) The activity constitutes a trade or business.

(2) The corporation actively participates in the management of the trade or business.

(3) There are at least three full-time nonowner employees of the taxpayer, substantially all of the services of whom are services directly related to such trade or business.

Such a stringent test would avoid opportunities for tax sheltering by closely held corporations, and yet eliminate the unfair penalties imposed upon closely held corporations engaged in legitimate business endeavors.

NEW SUBSIDIARY EXHIBIT A 6/9/82

EQUIP COST: 6202
PARENT CASH
CONTRIBUTION -1240

DEBT FINANCED: 4962

DEBT TERM: 15 YRS
INTEREST RATE: 15%

($000)

YEAR:	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
REVENUE	2790	2790	2790	2790	2790	2790	2790	2790	2790	2790	2790	2790	2790	2790	2790
LESS:															
DEPRECIATION	233	1039	1349	1302	1302	977									
INTEREST	744	729	711	690	666	638	607	571	529	482	427	363	291	207	111
OPERATING EX	1814	1814	1814	1814	1814	1814	1814	1814	1814	1814	1814	1814	1814	1814	1814
TAX INC(LOSS)	-1	-792	-1084	-1016	-992	-639	370	406	448	495	550	614	686	770	866
DEBT PRIN PMT:	104	120	138	159	182	210	241	277	319	367	422	485	558	642	738
SUB'S NET CASH FLOW DIVIDENDED TO PARENT------	129	128	128	128	129	129	129	129	129	128	128	129	128	128	128
PARENT'S BASIS (EXCESS LOSS ACCT) IN SUB	1111	192	-1019	-2162	-3282	-4049	-3808	-3531	-3212	-2845	-2423	-1938	-1380	-738	0
LOSSES NOT ALLOWED PER AT RISK RULE	0	0	1019	1016	992	639	0	0	0	0	0	0	0	0	0
DEFERRED USE OF LOSSES UNDER AT RSK	0	0	0	0	0	0	370	406	448	495	550	614	686	99	0

PARENT'S AFTER TAX CASH FLOW-UNDER AT RISK RULE*

-1112	492	157	128	129	129	129	129	129	128	128	129	128	-181	-271

PARENT'S RATE OF RETURN: 9.75%

PARENT'S AFTER TAX CASH FLOW-WITHOUT AT RISK LIMIT*

-1112	492	626	595	585	422	-41	-58	-77	-100	-125	-154	-188	-226	-271

PARENT'S RATE OF RETURN: 38.81%

---

*TAX RATE = 46% AND INVESTMENT TAX CREDIT IGNORED

Mr. HANCE. Thank you very much.

I would mention one thing. You also have with you David Glickman, who has served as Deputy Assistant Secretary for Tax Policy. It is always good to see him. I didn't know how he would look since he isn't with Mr. Chapoton up here testifying on some controversial proposal. We are glad to have him back.

At this time I want to take the liberty to call on Mr. Pickle to ask questions. He has a markup he has to participate in shortly. I am going to go out of regular order.

Mr. PICKLE. Thank you, Mr. Chairman. You are very considerate.

I want to join you first in welcoming Mr. Glickman back to our committee. He has changed appearance somewhat—looks more like a statesman than he did at times before our committee. We are glad to have him here. He gave us great service.

I also want to recognize Mr. Jim Jones. He is a constituent of mine, and a very valuable member of our district, who has helped focus the Nation's attention on the possibility of improvements in our tax code. The Nation is grateful to him.

I wasn't here earlier to hear your testimony, Mr. Jones, but I will read it.

If I might, I want to ask Mr. Hughes a couple of questions.

As I understand it, Mr. Hughes, you testified that you want to make some changes in this at risk provision with respect to closely held businesses. Does the bill that we have before us, H.R. 3475, address the at-risk problem of closely held businesses?

Mr. HUGHES. Mr. Pickle, the bill does indeed address the problem of at-risk in closely held businesses, but it limits its handling of these problems to S corporations.

Mr. PICKLE. Your solution then is to expand that measure to closely held businesses?

Mr. HUGHES. Closely held businesses that are taxed as businesses. They should be accorded the opportunity to have the losses of those businesses treated as the loss of the business, notwithstanding the fact that it is generated by a subsidiary, and closely held businesses also generally should be exempted from the at-risk provisions, if they conduct an active business—not if it is something susceptible of tax shelter.

Mr. PICKLE. You don't believe this would open up the provision to tax shelter abuse?

Mr. HUGHES. Mr. Pickle, we do not believe it would open up the provisions to tax shelter abuse for the simple reason that three full-time employees are required, an active business is required, and the business must be managed by the corporation itself. All of these are protections. These are protections that have been used in other contexts to prevent abuse by tax shelters.

Mr. PICKLE. I understand earlier today Mr. Perlman, a representative of the Treasury, made a statement in support of extending relief with regard to the at-risk loss limitation for closely held businesses, much as you have outlined. It seems to me with Treasury indicating its support—we could expand this.

Did you hear his statement on that?

Mr. HUGHES. Mr. Pickle, I did hear his statement on that. Indeed Mr. Perlman said in the course of that statement that he supported, Treasury supported, proposals like the one I have outlined for the correction of this inequity.

Mr. **Pickle**. I am glad to hear that. I had introduced a bill to accomplish the same thing. I am glad to get that on the record. I appreciate your testimony very much.

Thank you, Mr. Chairman. I appreciate your courtesy.

Mr. **Hance**. Thank you very much, Mr. Pickle.

Chairman **Rostenkowski**. We will now proceed with our last witness, Mr. Lehrfeld.

STATEMENT OF WILLIAM J. LEHRFELD, COUNSEL, SHRINERS HOSPITALS FOR CRIPPLED CHILDREN

Mr. **Lehrfeld**. Thank you, Mr. Chairman.

My name is William Lehrfeld. I serve as the national tax counsel for Shriners hospitals for crippled children, which is a 21-unit free hospital system throughout the United States for the benefit of crippled and burned children.

As a personal observation, we have two units in the State of Texas which accommodated 9,000 inpatient and outpatient visitations in 1982 at a total cost of over $10 million. As noted in the written statement, the Shriners hospitals are a free hospital system, which is rather unique in the United States today.

We are here in support of the principle stated in H.R. 3475, more specifically in section 401, dealing with reforming unqualified gifts of partial interests to charities. The problem arises in that in 1969 the Congress rewrote all of the rules governing gifts of property containing partial interests, part for the benefit of the charity, part for the benefit of private individuals.

The major form was a gift to a charitable remainder trust. As a result of the complexities introduced by the Congress in 1969, the Treasury at its own initiative enacted regulations which would permit unqualified transfers to be rewritten.

Beginning in 1974, your former colleague, Mr. James A. Burke of Massachusetts, supported legislation enacted in 1974, extended in 1976, extended again in 1978, and again in 1980, to temporarily permit reformations of unqualified transfers.

The current bill would provide permanent opportunities to reform otherwise unqualified transfers. However, unlike prior law and unlike the Treasury Department regulations, it imposes three conditions precedent before a taxpayer or decedent's estate may utilize the reformation process.

Two of them are rather important to Shriners hospitals, because of our acute experience in dealing with charitable remainder trusts. One is the requirement that there be an annuity trust or unitrust amount specified in the instrument if the instrument was executed after January 1, 1979.

The second is the actuarial comparison requirement, that the reformed remainder be within a 5-percent range of the present value of the unreformed remainder interest.

From the standpoint of symmetry in the tax laws, it would be nice to think that a cutoff date of January 1, 1979, would provide a basis for taxpayers to know that their instrument will not be reformed because they had not had even the most modest compliance with existing law. However, realty is such that even with that cutoff date, more than half of the 100 unqualified instruments now in our Tampa headquarters would not be able to qualify under this statute.

We would like to think that the taxpayers are adequately well advised that they could live with the January 1, 1979 cutoff. But experience simply does not bear that out. As a consequence, we ask the committee to consider removing the requirement that there be an annuity amount or unitrust amount specified in the instrument before reformation is possible.

In addition, the actuarial comparison, which is not approved by Treasury and not endorsed by the ABA, is just an open invitation to mischief, because as anyone will tell you that has any dealings in the area of probate, there is no way you can value certain forms of remainders, including those remainders that have invasion powers on them that are rather unique.

You add into that the problems associated with the possible change in the rate tables that are currently under consideration by the Treasury Department, and the possibilities of unisex tables being introduced in valuing the charitable remainder, it is an invitation to chaos.

We would like to point out that there are several other suggestions that could be taken by the committee.

No. 1, there is a clarification that once the trust is reformed, it is treated as a reformed trust for all purposes, including the income tax exemption and, No. 2, that the reformed trust will be treated as a private foundation in the application of the private foundation excise tax rules.

We would also like the committee to look and include in the bill something which it apparently intended to include but overlooked, namely a reopening of the statute of limitations. The press release of the chairman indicated there would be a reopening provision. We have been unable to locate it in section 401.

If the committee is going to add the reopening provision, we would hope that it would be written with close attention to the decision of the U.S. Court of Claims in a case entitled "Harris Trust and Savings Bank versus United States," which, when looking at a counterpart provision 7 years ago, faulted the Congress for not clearly providing how the statute of limitations would be reopened and with what effect.

Lastly, we would like to point out that Mr. Gibbons, the Congressman representing the Tampa area, has a bill in, H.R. 3252, that we believe contains more beneficial rules, including a provision which would permit a decedent's executor not to reform a trust, but to permit the contribution of the value of that unqualified trust to the charities' pooled income fund, and terminate the trust.

In the case of small contributions to charitable remainder trusts, it is often in the interests of everyone concerned not to fund the trust and give the property to charity using its own pooled income fund; it has the same effect but without the same vehicle.

I would also urge you to consider the possibilities of a valuation change where there is a premature termination of a life estate. In our written testimony we have two examples of where the Shriners hospital ended up with money, the entire estate, because of the premature death of the income beneficiary. And yet, despite the fact that the income beneficiary did not live past 6 months after the original decedent, Federal estate taxes had to be paid because of the actuarial computation of the expected lifespan.

Our recommendation in the Gibbons bill would permit a limited look forward rule, date of death to, for example, the date of the estate tax return being filed, and if the income beneficiary died during that period you would disregard his actuarial expectation and look at what the charity actually received in determining the amount of the charitable deduction.

Thank you, Mr. Chairman, for the opportunity to testify.

[The prepared statement follows:]

STATEMENT OF WILLIAM J. LEHRFELD, ESQ., ON BEHALF OF SHRINERS HOSPITAL FOR CRIPPLED CHILDREN

INTRODUCTION

The Shriners Hospitals for Crippled Children is a charitable institution organized in 1922 to provide free hospital services to crippled and burned children. In 1982, more than $84 million was spent on 21 hospitals serving tens of thousandss of children. In 1983, the figure will increase to over $96 million. Our hospital system is supported entirely by charitable contributions, earnings on the endowment, and fund raising activities carried on by the Shriner Fraternal Order. It receives no Federal or State money, no payments from patients, or their parents, or insurance carriers, and in this regard, it is truly a unique hospital system. Its entire services and facilities are provided free of charge to children in need. Our subsidy, if you will, consists of the broad range of incentives provided by the Federal and State tax laws which encourage individuals to make gifts, either outright or deferred in time, for the support, use and benefit of our 21 hospitals.

THE PERILS OF REFORM

Shriners Hospitals for Crippled Children has promoted and endorsed deferred giving for many years. The most common form of deferred gift is through the use of a charitable remainder trust described in section 664 of the Internal Revenue Code, although gifts to pooled income funds and non-trust gifts of remainders in farms and residences are also prevalent. These forms of gifts, partially to charity and partially to private persons, were dramatically altered in 1969.

Indeed, when the Tax Reform Act of 1969 was making its way through the Congress, we urged caution in making radical changes affecting the manner in which individuals may make contributions which are deferred in time, but are currently deductible, because of the long and, in our opinion, satisfactory history which deferred giving enjoyed in this country. We could perceive no abuses and, to this day, cannot agree with the assessment made then by staff that deferred giving, in its form prior to 1969, had actually been abused.[1] Being strong in asserting our right as a remainder beneficiary, the Shriners historically made the effort to assure itself that the fiduciary responsibility of a trustee took into account the competing interests of the income beneficiary and the charitable remaindermen. Because of our very strong concerns about the 1969 rules, we encouraged the Treasury Department in 1970 to permit, even absent statutory authorization, such as now under consideration, reformations of unqualified transfers made after the 1969 law's effective date because of the absence of any controlling regulations or dispositive rulings.[2]

---

[1] See, e.g., House Rept. 91-413 (Part 1), 91st Cong., 1st Sess., to accompany Tax Reform Act of 1969, August 2, 1969 at 58. Our evidence, based on actual experience, is to the contrary because we pursued our rights in charitable remainder trusts, e.g., *In re Estate of Gardner*, 5 Ariz. App. 239, 425 P. 2d 427 (1967) and the tax deduction was not abused. See, e.g., *Gardner* v. *United States*, 458 F.2d 1265 (9th Cir. 1972).

[2] Inc. Tax Regs. section 1.664-1(f)(3).

LEGISLATION ON POINT

Beginning in 1972, aware that the regulatory right to reform would expire, we pursued legislation in Congress to specifically authorize reformation.[3] Legislation was finally enacted in 1974,[4] extended in 1976,[5] further extended in time and expanded in scope in 1978,[6] and extended for the last time in 1980.[7] Charitable institutions have now been able to convince the Treasury Department and various Members of the Congress that permanent reformation is in the national interest: That is, if the Congress is going to insist that the stringent rules governing deferred giving are to remain in the Internal Revenue Code, then donors must be given the opportunity to revise their nonconforming instruments regardless of how close or how far these instruments may be to compliance with the requirements of the law, the regulations or IRS administrative practice. We therefore endorse, in principle, section 401 of H.R. 3475 and its effort to provide permanent relief to unqualified transfers to charitable remainder annuity trusts, and unitrusts, and charitable lead trusts, not now meeting the requirements of IRC sections 170(f)(2), or 2055(e)(2)(A) or (B), or 2522(c)(2)(A) or (B). Despite our endorsement, we urge two major deletions in the proposed legislation to enhance its use, enlarge its value, and simplify its administration. While we prefer the Gibbons bill on this same subject matter, H.R. 3252, we would gladly work toward incorporating the strengths of both bills in the final version of reformation legislation.

MAJOR OBJECTIONS

Two provisions of section 401 turn their back on the original regulations of the Treasury Department which authorized reformations until 1972, and on the expired legislation that exists today. We are unable to perceive how the narrowing of existing law in any way promotes the interest of the charitable institutions the legislation was designed to assist, nor the interests of the Treasury in regulating "qualified" trusts under the private foundation penalty taxes.

More specifically, we do not believe that there is a need for a requirement that there be a 5 percent range in the actuarial computation of the reformable interest as evidenced by proposed IRC section 2055(e)(3)(B)(i). We strongly disagree that there is any need for a reformable interest to be expressed either in specified dollar amounts or in a fixed percentage of the fair market value of the property, even if the rule is limited to wills executed after January 1, 1979, as now set out in proposed IRC section 2055(e)(3)(C)(ii).

Let me illustrate our objections to this provision. One recent case involved a widow from Dayton, Ohio, who left her entire estate, some $520,000, to a trust, naming her only child as the beneficiary for "all the net income." The trustee, a national bank, had invasion powers to "maintain and support" the son. Within 3 months after the mother died, her 47-year old son died, both from congestive heart failure. Under prior law (IRC section 2055(e)(3)), the estate was entitled to a $120,000 charitable deduction because of the value of the son's intervening interest, but it actually received almost $500,000. Had this will been drafted after January 1, 1979, no charitable deduction would have been allowed despite our actual receipt of the entire estate.[8]

---

[3] See, Congressional Record Oct. 16, 1972, daily edition, where a floor amendment was offered to H.R. 7377 by Senator Clifford Hansen (R.-Wyo.), which was later withdrawn due to procedural objections. Substantially all of Senator Hansen's 1972 amendment is now embodied in section 2055(e)(3) of the Internal Revenue Code.

[4] Public Law 93-483, section 3(a), Oct. 26, 1974, permitted reformations from 1970 through Dec. 31, 1975. For explanation, see S. Rep. 93-1063, 93rd Cong., 2d Sess., Aug. 1, 1974 at pp. 3-4. For original testimony, see Cong. Rec. Oct. 25, 1973, at 35029-35032. The House sponsor of the original legislation explained in considerable detail how he expected the legislation to be construed, when it was ready for final passage in the House. See Congressional Record Oct. 11, 1974, 35460, statement of Congressman James A. Burke (D-Mass.)

[5] Public Law 95-455, section 1304(a), Oct. 4, 1976, permitted reformations from 1970 to 1977. For explanation, see House Rept. 94-1268, 94th Cong., 2d Sess., June 16, 1976. Section 1304(b) of the 1976 act permitted otherwise closed estates to be reopened to permit reformation; this was also apparently intended in the 1983 legislation (statement of Mr. Rostenkowski, June 30, 1983, Congressional Record at H4884) but overlooked in the initial version of section 401 of H.R. 3475. Charitable trust reformations only permit refunds for the ensuing allowable deduction where the limitation period is either open or explicitly reopened by law. *Harris Trust and Savings Bank, executor* v. *United States*, 646 7.2d 480 (Ct. Cl. 1981).

[6] Public Law 95-600, section 514(a), Nov. 6, 1978, permitted reformations from 1970 to 1978 and was expanded to include deductions for charitable lead trusts, and the partial charitable lead in a reformed charitable remainder trust and then extended deductions to the gift tax and the income tax pursuant to regulations to be issued by the Secretary of the Treasury. No such conforming regulations have been issued as of July 25, 1983. Due to a drafting error, an effective date provision had to be added for compliance purposes under Sec. 105(a)(4)(B) of Public Law 96-222, Apr. 1, 1980, for purposes of section 514 of Public Law 95-600, supra.

[7] Public Law 96-605, section 301(a), Dec. 28, 1980, permitted reformation from 1970 to 1981.

In another case, a woman left her entire estate of $470,000 in trust, including her residence, to pay her husband $750 per month, plus all taxes due on such sums, plus $25 per month due for flowers for a niche in a columbarium in Oakland, Calif. The trust was until the husband's death, or remarriage, whichever first occurred. The husband died less than 6 months after his wife. Again, we received almost the entire estate of almost $450,000, less the monthly annuity amounts due, including the residence, reduced by Federal and state death taxes, using the husband's life expectancy as the measure.[9] Despite receiving all of this, H.R. 3475 would bar any charitable deduction for the reformable trust and for the value of the residence (since it passed within the unqualified trust).

Lastly, though of considerably less importance, we do not believe that there is any need for a rule which requires the reformable interest to be susceptible of qualifying under the rules governing gifts of charitable remainders before 1969 in order for it to be reformable as evidenced by proposed IRC section 2055(e)(3)(C)(i).[10] None of these conditions was explicated in prior law, or evidenced by existing Treasury Regulations nor by the noncodified provisions of pertinent Revenue Acts.[11] The precondition of an annuity or unitrust amount (IRC section 2055(e)(3)(C)(ii)) will exclude half or more of the now unqualifying instruments creating charitable remainder trusts from the opportunity to reform, if we disregard the startup date of January 1, 1979. More than half of the unqualified charitable remainder trusts which our legal office sees are contained in wills of decedents who provided their spouses with an income interest or with some invasion or termination provisions creating other conflicts with this bill.

Because of time constraints, I cannot provide extensive examples of our experience in dealing with pre-reformation valuation questions (to be required by proposed IRC section 2055(e)(3)(B)) but will furnish a description of our experience with such problems under separate cover to Committee staff for inclusion in the record of this hearing. In summary, not one of those three conditions is justified by any litigation in the thirteen years in which the regulations and prior law were effective; none of these provisions can be justified from the standpoint of preventing alleged abuses of the reformation procedure and none of the three simplifies the reformation process. These three conditions are open invitations to members of the public, or affected charities, to come again to the Congress to seek relief and be independently challenged by succeeding Congresses who perhaps cannot perceive what you today, in the original version of section 401 of H.R. 3475, seek to accomplish. By eliminating them all, you may save yourselves, or your successors, from additional work in this already too complex area of the Internal revenue Code.

THE GIBBONS REMEDY

None of the objections outlined above are contained in Mr. Gibbons' bill, H.R. 3252. First, Mr. Gibbons' bill permits all forms of transfers for charitable purposes which are claimed by the Internal Revenue Service not to qualify under any of the existing partial interest rules (income, estate or gift tax) to be reformed. For example, Mr. Gibbons' bill would permit an unqualified gift to a charity's pooled income fund to be conformed which is not the case for H.R. 3475. Indeed, even the fund itself could conform its activities or instrument under the Gibbons bill should an IRS challenge arise.[12] Second, his bill also clearly states that a reformed charitable remainder trust is treated as a qualified trust for all purposes of the reformation including, by example, the application of section 664(c) and 4947(a)(2) of the Code.

---

[8] *Shriners Hospitals for Crippled Children* v. *United States*, 602 F.2d 306 (Ct. Cl. 1979).

[9] *Wells Fargo Bank* v. *United States*, 44 AFTR 2d 79-6195, 1979-2 USTC ¶ 13,317 (N.D. Calif. 1979).

[10] Proposed IRC section 2055(e)(3)(C)(i) has a "but for" rule which incorporates, and legalizes, the Tax Court's theory (*Estate of Virginia Humbert*, 70 T.C. 542 (1978)), which is an IRS litigating strategy using legislative history documents which we believe have been misconstrued, and read incompletely.

[11] *Cf.* Regulations section 1.664-1(f)(3) and temporary regulations section 24.1(h), T.D. 7393, Cum. Bull. 1976-1, 283. This proposal of a "look back" to pre-1969 standards presents IRS, and the courts, with a "two-step analysis" (*Strafford National Bank* v. *United States*, ——— F. Supp. ———, 48 AFTR 2d 81-6245, 1981-2 USTC ¶ 13,414 (D.N.H. 1981).

[12] IRC section 6429c)(5). The disqualification may be either caused by the terms of the transfer to the fund or because the fund has been retroactively disqualified by an IRS action. Cf., *Moody Bible Institute, Trustee* v. *United States*, Civil No. 82 C 4015, U.S. District Court, N.D. Ill. (attempted disqualification of a charity's pooled fund because of its distribution as income, to private beneficiaries, amounts of dividends paid trust fund by public utilities which deemed a portion of their dividends to be nontaxable returns of capital).

Third, Mr. Gibbons' bill also reopens the statute of limitations for otherwise closed estates, which H.R. 3475 purports to do but did not.[13]

A technical explanation of the intention, coverage and construction of H.R. 3252, on this subject, is attached for the information of the committee.

If there is no objection, we will be glad to submit, in detail, a legal memorandum pointing out certain technical problems which we perceive exist under section 401 of H.R. 3475 and which do not exist under H.R. 3252.

We thank you for your attention to this matter and welcome any questions from the panel.

---

[13] Congressional Record, June 30, 1983 at H4884; Cf., section 1304(b), Public Law 94-455 and note 5, herein.

98TH CONGRESS
1ST SESSION

H. R. 3252

To amend the Internal Revenue Code of 1954 with respect to amendments of certain transfers for charitable purposes, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

JUNE 8, 1983

Mr. GIBBONS introduced the following bill; which was referred to the Committee on Ways and Means

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to amendments of certain transfers for charitable purposes, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. Section 170A of the Internal Revenue Code is hereby enacted to read as follows:

"SEC. 170A. AMENDMENT OF UNQUALIFIED CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

"(a) ALLOWANCE OF DEDUCTION.—If a charitable deduction is not allowable at the time of the donor's transfer (including a decedent's death) because of the failure of an interest in property which passes or has passed from the donor to a person, or for a use, described in section 170(c)(2)(B), to meet the requirements of paragraphs (2) or (3) of section 170(f) (or the provisions of sections 2055(e)(2) or 2522(c)(2)) and if the governing instrument is amended or conformed so that the interest meets the requirements of such paragraph (2) or (3) of section 170(f) (or section 2055(e)(2) or section 2522(c)(2), as the case may be), a deduction shall nevertheless be allowed and the transfer shall be treated, for all purposes of this subtitle, as a qualified transfer. The Secretary or his delegate may, by regulation, provide for the application of the provisions of this subsection to trusts or other governing instruments which are amended or conformed in accordance with this section and such regulations may provide for any adjustments in the application of the provisions of section 508 (relating to special rules with respect to section 501(c)(3) organizations), subchapter J (relating to estates, trusts, beneficiaries, and decedents), and chapter 42 (relating to private foundations), made necessary by the application of this section. If, by the due date for the filing of any tax return (including any extension thereof), with respect to an income, gift, or estate-tax charitable deduction, the reformable interest is in a charitable trust, which, upon allowance of a deduction would be described in section 4947(a)(1), or the interest passes or has passed directly to a person or for a use described in section 170(c)(2)(B), a deduction shall be allowed as if the governing instrument was amended or conformed herein.

"(b) EXCHANGE OF PARTIAL INTEREST.—Pursuant to regulations promulgated by the Secretary or his delegate, an income interest or remainder interest transferred for charitable purposes may be adjusted or exchanged for a similar interest provided the donee organization receives an interest in property not less in value than the value of the original transfer: *Provided, however,* That no deduction shall be allowed in connection with the value of any transfer under this section for an amount which is treated as passing from a person other than the donor.

"(c) SPECIAL RULE FOR ESTATE AND GIFT TAX VALUATIONS.—If, by the due date for the filing of any estate or gift tax return (including any extension thereof), the reformable interest is in a charitable trust, which upon the allowance of a deduction would be described in section 4947(a)(1), or the interest passes directly to a person or for a use described in section 170(c)(2)(B), a deduction shall be allowed if the governing instrument is not amended under this paragraph and the termination of all intervening estates was by reason of death. In that case, the death of the intervening interest shall be treated as a disclaimer of said interest in the valuation of the property passing to charity."

SEC. 2. Section 2055(f) is amended to add at the end thereof:

"(12) For special rules as to valuation of certain gifts of remainder interests in charity, see section 170A."

SEC. 3. SPECIAL RULE FOR CHARITABLE REMAINDER TRUSTS WITH RESPECT TO INTEREST OVERPAYMENTS.—Enactment of section 6601(l).

"(l) NO INTEREST ON CERTAIN ADJUSTMENTS AND REFUNDS ARISING OUT OF THE APPLICATION OF SECTION 170A.—If a charitable deduction is not allowable at the time tax is due because of the failure of the governing instrument of the transfer to charity to meet the requirements of section 170 (f)(2) or (f)(3), section 2055(e)(2) or section 2522(c)(2), and said instrument is reformed pursuant to section 170A, the failure to pay tax when due shall not be regarded as an underpayment of tax for purposes of the application of this section."

SEC. 4. EXTENSION OF PERIOD FOR FILING CLAIM FOR REFUND OF INCOME, ESTATE, OR GIFT TAX PAID.—A claim for credit or refund of an overpayment of tax imposed under this subtitle allowable by reason of the application of section 170A of the Internal Revenue Code shall not be denied because of the expiration of time for filing such a claim under section 6511(a) if such claim is filed not later than December 31, 1985: *Provided, however,* That no interest shall be allowed with respect to the amount of income, estate, or gift tax paid resulting in the overpayment arising as a result of the application of this section and section 170A of the Internal Revenue Code.

SEC. 5. EFFECTIVE DATE.—The amendments made by section 1 shall apply in the case of a decedent's dying after December 31, 1969, or for transfers (in trust or otherwise) after July 31, 1969. For purposes of the application of the effective-date provisions contained herein, a transfer is deemed to have occurred when the transfer first becomes irrevocable.

EXPLANATION OF BILL RELATING TO REFORMATIONS OF UNQUALIFIED CHARITABLE CONTRIBUTIONS

The bill establishes section 170A of the Internal Revenue Code to permit reformations of various forms of unqualified transfers to charity (due to the existing partial interest rules); in so doing, it allows reformed gifts to take altered formats utilizing, in part, the convenience of the parties to the gift; it treats the premature death of an income beneficiary of a charitable remainder trust as the equivalent of a disclaimer in connection with valuation of the property passing to charity, and overrules a revenue ruling authorizing the imposition of an interest charge where a reformation is not concluded by the due date for the estate tax return. It also permits the period of limitations to be re-opened until December 31, 1985 to allow tax benefits to accrue for otherwise closed estates; it also provides an effective date provisions which conforms to all of the prior provisions under the law which expired in 1981.

Section 1 of the bill enacts subsections (a), (b) and (c) of new Internal Revenue Code section 170A.

Section 170A(a) provides for relief of nondeductible transfers of partial interests in property to charity. It permits the allowance of an income tax, estate or gift tax charitable deduction, as the case may be, if the unqualified interest is reformed to meet the objections of either IRC section 170(f)(2) or (f)(3), 2055(e)(2), or 2522(c)(2). If a reformation of the governing instrument is made to meet the objections of these various Code provisions, a charitable deduction is allowed and the transfer is treated, for all purposes, as a qualified transfer. In brief, this means that if the transfer is, for example, a transfer to a charitable remainder trust, not only will the appropriate charitable deduction be allowed, but the qualified charitable remainder trust will be exempt from federal income tax under Int. Rev. Code Sec. 664(c) during the term of the trust. This section will permit reformation of gifts to unqualified charitable remainder trusts (including pooled income funds), unqualified charitable lead trusts and wholly charitable transfers where Internal Revenue Service alleges an unqualified partial interest exists to disqualify the gift. It would also apply to gifts of remainders in farms and residences.

A provision is inserted in the text of the reformation provision to authorize the Secretary of his delegate to provide for adjustments in the application of other Code provisions affected by reformation in order to enhance its use, protect the parties from the retroactive application of the private foundation excise taxes and to avoid situations giving donors or estate unintended benefits. Reasonable regulatory authority for Internal Revenue Service administration actions under comparable provisions of prior law was approved in *Shriners Hospitals for Crippled Children* v. *United States,* 602 F. 2d 302 (Ct.Cl. 1979). Section 170A(a) also provides that if, by the due date of a return, the interest is already in a charitable trust or has passed directly for a charitable purpose, the deduction would be allowed as if the governing instrument was amended; such a "deemed" reformation provision conforms to prior law.

Section 170A(a) conforms in purpose and intention to the provisons of Internal Revenue Code section 2055(e)(3) as adopted in 1974 and as altered and extended by section 514 (a) and (b) of the Revenue Act of 1978 (requiring income and gift tax reformation rights equivalent to the estate tax rights of existing law and extending reformation rights available to charitable remainder trusts to charitable lead trusts). The qualification of the trust under the law prior to 1969 is irrelevant thus removing an obstacle to a reformation's validity created by *Estate of Virginia Humbert,* 70 T.C. 542 (1978).

Section 170A(b), dealing with the exchange of partial interests, is a new provision intended to permit the parties to an unqualified transfer viz, the trustee, the charitable donee and the private income beneficiary, to reform the interest into one which does not entirely conform to the apparent original intentioins of the unqualified transfer. Thus, for example, a transfer by a decedent to an unqualified charitable remainder trust created by his will could be altered to become a transfer to the charity's pooled income fund for the term and value consistent with the limits of the law governing such transfers. Similarly, a transfer of an annuity in trust to an individual as part of an unqualified charitable remainder trust would permit the opportunity for the estate to purchase an annuity commercially and permit the remainder of the estate to pass directly to charity (this would overrule decisions such as *Oetting* v. *United States,* 544 F. Supp. 24 (E.D. Mo. 1982), 50 AFTR 2d 82-6171, 1982-2 USTC ¶ 13,479). This exchange would not increase the charitable deduction over the present value of the original transfer to charity since any increase in the value of property passing directly to charity would be treated as passing from other than the decedent. Likewise, if a transfer was made to an unqualified charitable remainder trust and the transfer included the remainder interest in a farm or personal residence, the statute would permit the reformation of the gift so that a legal life estate was provided for in the case of the remainder interest in the farm and the trust could be reformed to otherwise conform to the requirements of law. See, *Ellis First National Bank of Bradenton* v. *United States,* 550 F. 2d 9 (Ct. Cl. 1977). Taking the residence or farm out of the charitable remainder trust is necessary upon reformation because of the application of the chapter 42 rules (such as self dealing) to a circumstance where a disqualified person (e.g. a spouse) might continue to reside on the farm or residence and if said farm or residence remainder remained in trust, the individual would be subject to excise taxes. In no event would a reformation be permitted to give the donor (including a donor's estate) a charitable contribution deduction greater in value than the original transfer had the original transfer not been disqualified by reason of the application of the partial interest rules.

Section 170A(c) provides a special rule in the valuation of charitable gifts by ignoring the intervening life estate (for estate and gift tax purposes only) if the intervening life estate terminates by reason of death within a short time after the death of the decedent. In part, this rule is already part of existing law where, at the time of decedent's death, the income beneficiary is terminally ill. *Estate of Jennings,* 10 T.C. 323 (1948); Rev. Rul. 80-80, C.B. 1980-1, 194. In such a circumstance, the value of the charitable deduction disregards the intervening interest. In very limited circumstances, the Internal Revenue Service in the administrative expense deduction for estate taxes, has argued for a limited "look forward" rule ignoring the status of events at date of death to determine actual rights or liabilities shortly thereafter. *Chesterton Estate* v. *United States,* 551 F.2d 278 (Ct.Cl. 1977). Because the Congress in 1969 sought to more closely equate the value of the charitable deduction with the value of the property passing to charity,[1] it was believed that providing this additional amount of charitable deduction in recognition of what the charity actually receives shortly after the decedent's death, due to the premature death of an income beneficiary, more fully carries out Congressional intent than by directly applying the actuarial tables which would be the case under such decisions as *Merchants National Bank* v. *United States,* 583 F.2d 19 (1st Cir. 1978); *Ithaca Trust Company* v. *United States,* 279 U.S. 151 (1929).

Section 2 of the bill provides a cross-reference to the estate tax provisions dealing with valuation.

Section 3 of the bill provides a special rule dealing with the attempt, by the Internal Revenue Service, to apply interest in the estate tax area to a temporary deficiency where a reformation connection with a decedent's estate did not occur by the time of the due date for the estate tax return but which later did occur to provide a charitable deduction and reduce or eliminate the temporary deficiency. See generally, Rev. Rul. 80-291, C.B. 1980-2, 373. The revenue ruling fails to recognize that, under existing regulations, and under the provisions of Int. Rev. Code Sec. 2055(e)(3), the reformation is deemed to accrue as of the date of the decedent's death and, therefore, was fully retroactive in effect. By imposing an interest penalty for the failure of the executor to fulfill the reformation responsibility by the due date for the return, the Internal Revenue Service has confused the definition of "tax" in determining whether any particular underpayment is a "tax" upon which interest is due and imposes a penalty on reformation which the Congress did not deem to be necessary in the initial enactment of Sec. 2055(e)(3) or in any of the three extensions. In order to avoid litigation on this particular point, overruling the revenue ruling was considered appropriate.

Section 4 of the bill permits the filing for refund claims (or for credits) in connection with the reformation (or a reformation to occur) even if the estate or transfer was otherwise closed by the limitation provisions of Internal Revenue Code section 6511(a). This permits an otherwise closed estate to reform the existing trust (one which continued even after the close of the period of limitations as to the estate tax liability) and permit the estate to obtain the refund, if the estate is open under local law, or the trust as its beneficiary, thereby enhancing the value of these reformation rights. No interest is payable on such refunds. The Congress intends that this right to re-open otherwise closed estates is only extended for estate and gift tax purposes, or in connection with the income tax exemption of a qualified charitable remainder (including a pooled income fund) trust because, in that way, the primary beneficiary of the re-opening will be the charity itself and not the donor (which would be the case in connection with an unqualified income tax deduction for an otherwise closed return).

---

[1] House Rept. 91-413 (Part 1), 91st Cong., 1st sess., C.B. 1969-3, 200, at 237; Senate Rept. 91-552, 91st Cong., 1st sess., C.B. 1969-3, 423 at 479.

Section 5 provides for a retroactive effective date consistent with all of the prior provisions dealing with reformations.

Mr. HANCE. Thank you very much.

Mr. Duncan?

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to thank all the panels. The last may have been the best, or at least equal to the best panel we have had today.

Mr. Jones, you touched on a question on which I think all the members are receiving quite a bit of mail, the flat rate tax on the gross income. A couple of years ago we had a study made here at the committee which indicated that if we had a flat rate middle and lower income people would pay more taxes and wealthy people would pay less.

Would you care to comment on that?

Mr. JONES. Well, really what I am advocating is not a flat-rate tax as such. I agree with what the committee findings were on that. What I advocate is a business-oriented tax based on gross income, and it can have a single or flat rate tax on it.

Actually, that is a minor consideration in my view—just the base of the tax is really important. So I am not advocating a flat-rate tax per se.

Mr. DUNCAN. You did advocate that at one time, didn't you?

Mr. JONES. No; I always advocated a gross income tax, never a flat-rate. It has been brought up in several conferences as a flat rate tax. But there is an important difference. It is the base rather than the rate that is important.

Mr. DUNCAN. Thank you, sir.

Thank you, Mr. Chairman.

Mr. HANCE. Let me expand a little on the question that Mr. Duncan asked you, Mr. Jones.

Under your proposal, it might be we would still have progressive tax rates, but the individuals would just be paying on gross income without all the deductions minus inventory?

Mr. JONES. Right; actually, I would eliminate all deductions. But if the Congress wants to use the tax system for some of the purposes they have been using it, I would do that in the form of a credit, because a deduction makes the tax system highly subjective. Just about every taxpayer writes his own taxes, especially business people, including myself. But if you put it on the basis of tax credits, below the line, everybody gets a fair shake from the tax system. That is what I advocate, tax credits rather than any deductions above the line.

Mr. HANCE. We have a bill pending before this committee that would call for a study by the Treasury Department that would give a detailed accounting of what the rates would be, how much revenue would be needed and how the proposal would work.

Do you have any figures or any estimates on what you think the rate would be?

Mr. JONES. Yes; I had an independent economic study made. It appears that it should be between 4½ and 5½ percent. However, it was brought to my attention that at the time that study was made the tax bite from the gross national product was about 17½ to 18 percent. Today I think it is 21 or 22 percent. So we would have to revise that.

Mr. HANCE. About 19 percent, going to 20?

Mr. JONES. Anyway, it is going to vary with the gross national product.

Mr. HANCE. It dropped down after 1981, after the 1981 tax cut bill was passed. It dropped down below 20 percent. But many of us believe it is headed back up above 20 percent.

Mr. Silverman, you testified that enrolled agents should be allowed to participate in small cases, below $5,000.

Mr. SILVERMAN. Correct.

Mr. HANCE. What opposition has there been to this?

Mr. SILVERMAN. We heard the chief judge of the Tax Court express his opposition. He made the statement that if something is not broken, don't fix it.

Our association noticed that many of our clients have to leave our offices and have to disassociate themselves with the certified public accountant or enrolled agent when they want to avail themslves of a rather simplified proceeding.

The court docket on the graphs which were indicated or exhibited this morning clearly indicates the escalation of the number of cases that the court is straining under. The chief judge of the court said it is a workable system, the procedure is workable. What is not workable is that taxpayers find themselves having to go alone and the court has to act as sort of their advocate.

We think this is wrong. The court should not have to explain what a deduction is in a petition. The purpose of the court should be that of an impartial referee, not assisting somebody in presenting their case.

I believe that the chief judge's opposition is incorrect. In a letter to the Assistant Secretary for Tax Policy, he said that the court is not opposed to having enrolled agents or certified public accountants assist taxpayers, but he doesn't want official recognition. We feel that this is an inconsistent position by the judge.

I personally feel it is a distinction without a difference. And we believe that the right of the taxpayer to a quick, impartial hearing without having to retain the services of an attorney and start the whole process from square one all over again would be enhanced by allowing enrolled agents or CPA's to practice before the Tax Court under the S or small case procedure.

Mr. HANCE. I wasn't here for the judge's testimony. The bar association also testified. What did they say?

Mr. SILVERMAN. The bar association said that they would defer to the court, that the court should regulate who should practice before it. The bar didn't have any opposition one way or the other. They just felt it was up to the discretion of the court.

Our association doesn't believe that the answer to this problem can be solved exclusively by greater Government appropriations. We don't want to be lawyers. But since 90-odd percent of the cases are settled through the settlement process, we believe that the qualified expert, so to speak, who prepared the return is best qualified and could enhance the settlement process by continuing to represent the taxpayer in this type of proceeding.

In fact, through my service on the Commission of the Internal Revenue's advisory group, when discussing this whole pro se problem, a number of suggestions were put forth, and one of them was to make the small case procedure the rule, and that you had to elect out of it.

If you had a factual situation, just because you were precluded under the dollar limit, you should make every case mandatory, to simplify the whole process, unless an individual elects out of that, or perhaps even raise the dollar limit.

Mr. HANCE. I would think that you are not going to have that many tax lawyers clamoring among themselves to want to handle a lot of those cases.

Mr. SILVERMAN. That is true. That is the real thrust of our argument. It places a burden on the taxpayer.

I practice in New York City. I will give you an example.

I had a client in a half a million dollar dispute over a lease. We went to a leading litigation firm, and the firm told us that the amount was too small for them to handle.

Lawyers who specialize in taxes or who work for large firms that specialize in taxes, I don't believe they are interested in handling these cases. Therefore, I think many of the taxpayers under pro se, not knowing how to proceed, they can no longer use the services of the accountant or enrolled agent who prepared the return. And I think this would truly enhance the right of the individual taxpayer to a quick, fair, and less costly method than the one that is currently available to them.

Mr. HANCE. Thank you very much.

Are there any additional questions?

If not, thank you gentlemen for being here. We appreciate your testimony.

The meeting is adjourned.

[Whereupon, at 1:15 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF ALLEGHENY INTERNATIONAL, INC.

SUMMARY OF COMMENTS

Allegheny International, Inc., a Pittsburgh-based multinational producer of industrial specialities and utilitarian consumer products, supports the stated objectives of

H.R. 3475, which are to simplify and improve the tax law. We believe, however, that these goals would be more fully met and certain inequities under the present law corrected if H.R. 3475 were amended to include the foreign tax credit provisions contained in H.R. 3140, introduced on May 25, 1983, by Representatives Gibbons, Conable, Duncan and Jenkins. Specifically, Title VIII of H.R. 3475 should be modified to allow the foreign tax credit a three year carryback/fifteen year carryforward period as well as FIFO ordering rules for utilization of the credit. In addition, a "mirror-image" provision should be added to section 904(f) of the Internal Revenue Code whereby a company could recapture domestic losses in subsequent years in which it has domestic income by recharacterizing the subsequent domestic income as foreign source income to the extent that domestic losses have served to reduce the foreign tax credit available to the taxpayer.

The stated objective of H.R. 3475 are only partially met in the area involving income tax credits

In his statement introducing H.R. 3475, Representative Rostenkowski asserted (June 30, 1983, Congressional Record, p. H 4881) that Title VIII of the proposed bill would simplify and rationalize the income tax credit provisions in the Internal Revenue Code. This would be done by grouping the existing credits into three "logical categories". In addition, the various rules concerning limitations and carryovers would be conformed and simplified by allowing business credits, the third such category of tax credits, a uniform 3-year carryback and 15-year carryforward. Further, all credits in this last category would be utilized on a FIFO basis, thereby allowing the oldest credits to be used first. We strongly believe that significantly greater simplicity, conformity, and equity could be achieved by also applying the carryover and utilization rules to the foreign tax credit and by adding a provision dealing with the treatment of domestic losses in the computation of this credit.

The stated objectives of H.R. 3475 would be further by the inclusion of provisions concerning the foreign tax credit.

The need for conformity of the foreign tax credit rules to those of the business credits is domonstrated by the inequity of the present rules and the adverse effects which they have on the foreign operations of U.S. companies. The 2-year carryback and 5-year carryforward provisions of the foreign tax credit are clearly unfavorable when compared with the 3-year carryback and 15-year carryforward provisions for net operating losses and the investment tax credit. There is no readily explainable reason for the harsher rules in the foreign tax credit area. In fact, when each was originally enacted as part of the 1954 Code, the carryforward/carryback provisions pertaining to the net operating loss and the foreign tax credit were identical—two years back and five years forward. Although the rules have been liberalized several times for net operating losses since 1954, the foreign tax credit provisions have, for no apparent reason, been subtantially ignored. In addition, the foreign tax credit rules require that the current year's credits be utilized before any carryovers. By contrast, with respect to the investment tax credit and net operating losses, a carryover is to be used first, before the current year's credits, to afford the taxpayer the maximum opportunity of using the credit.

The relative harshness of these rules in the foreign tax credit area is even more apparent when it is recognized that the foreign tax credit is not a tax benefit or a tax preference. Rather, the foreign tax credit is supposed to be a mechanism for the prevention of the imposition of a second level of taxation on income on which tax has beem previously paid. The foreign tax credit should thus be accorded treatment which gives recognition to the concept that utilization of the foreign tax credit is merely the reflection of a prepayment of income taxes to the jurisdiction in which income is earned.

This lack of consistency and equity in the Code penalizes multinational taxpayers who experience domestic operating losses, with the result that the government often reaps a windfall at the expense of distressed taxpayers. Consider, for example, a situation where a company is projecting net operating losses for both 1983 and 1984. These losses will be carried back to 1980 and 1981, respectively, possibly reducing taxable income in each of these years to zero. Because of the loss carrybacks to 1980 and 1981, the foreign tax credit attributable to the taxes paid in those two years could be carried back two years and forward five. If the foreign tax credits cannot be used in years prior to 1980, the only alternative is to carry the credits forward up to 1986. With respect to the 1980 credits, for example, this means that 1985 will be the last year available to absorb the 1980 credits and then only if there is still a limitation available after absorbing any 1985 credits. Thus, in this example, the 1980 credit carryover, triggered by a 1983 loss, must be absorded in 1985 or double taxation of the 1980 foreign income will result when the income from the foreign subsidiaries is repatriated.

H.R. 3475 could also cure and inequity in the computation of the foreign tax credit

The present rules contain an inequity in the manner in which corporations are able to realize the foreign tax credit. Section 904(f) was enacted as part of the Tax Reform Act of 1976 for the purpose of eliminating the tax benefit which could be procured where a taxpayer had taxable income from U.S. sources but losses from foreign sources. The foreign losses had the effect of reducing U.S. taxable income and taxes by decreasing the taxpayer's worldwide taxable income, on which the U.S. tax is based. When the business operations in the foreign countries subsequently became profitable, the foreign tax credit was allowed for the taxes paid to the foreign country in the subsequent year. Thus, in certain situations, the taxpayer could receive a U.S. tax benefit when income was derived from that country because, by use of the foreign tax credit, no U.S. tax was paid on income from that country, even though earlier losses from that country had served to reduce the taxpayer's tax on its U.S. income.

The present law eliminated the possibility of the foregoing tax benefit by means of the foreign loss recapture rule of section 904(f), which provides that, in cases where a loss from foreign operations reduces U.S. tax on U.S. source income, the taxpayer is, in effect, required to recapture the tax benefit if the company subsequently derives taxable income from its foreign sources. The recapture is accomplished by treating a portion of subsequent foreign source income as income from domestic sources, thereby reducing the allowable foreign tax credit for the year.

The present law, however, can produce a double tax detriment. Many corporations now find themselves with substantial domestic losses but net income from foreign sources. A company thus may have paid foreign tax on foreign source income but have excess foreign tax credits which are unlikely to be used. This situation was brought about by the failure of Congress to provide a parallel provisión for the recapture of domestic losses to avoid double taxation.

A technical, rather than substantive, change should therefore be made to the foreign tax credit rules to provide for a "mirror-image" provision to section 904(f). Under such a provision, the company could recapture domestic losses in subsequent years in which it has domestic income by recharacterizing the subsequent domestic income as foreign source income, to the extend that domestic losses have served to reduce the foreign tax credits available to the taxpayer. Technical provisions of this nature may be found in H.R. 3140, the Foreign Conformity Act of 1983, introduced by Representatives Gibbons, Conable, Duncan, and Jenkins, as well as in the companion bill introduced in the Senate by Senator Danforth as S. 1584.

Inclusion in H.R. 3475 of provisions concerning the foreign tax credit would strengthen the ability of U.S. business to compete in international markets

The need for extension of the carryforward rules, application of the FIFO ordering rules, and a mirror-image provision to section 904(f) is evident from the fact that, under the present rules, taxpayers are losing a substantial portion (if not all) of foreign tax credits previously earned. This harsh result in the foreign tax credit area undermines the intent behind the NOL carryback/carryforward rules because the net operating loss relief is effectively reduced by the previously allowed foreign tax credits which now may never be used. The current foreign tax credit rules, therefore, place an even larger burden on a distressed company trying to recover from a loss position. This burden result in a competitive disadvantage to U.S. corporations which are active in foreign commerce. At a time when the world economy is in a turbulent and hence highly competitive condition, this is particularly onerous and is likely to result in the withdrawal of U.S. businesses from foreign markets.

The present carryback/carryover rules can also adversely affect the cash flow from foreign subsidiaries. A company's inability to utilize the foreign tax credits associated with dividends that would otherwise have been repartriated from foreign subsidiaries, in combination with the doubtful outlook for ultimate realization of the credits within the carryback/carryover period, might well lead the company to defer dividends planned from these companies. Such a company simply could not risk having the carryover period expire before the credit could be utilized. This possibility is especially troublesome where the company has short-term borrowings outstanding against which the cash dividends could be applied. In such a case, the cash generated by foreign subsidiaries would remain in foreign bank accounts to the benefit of the credit markets outside of the United States while the parent company was compelled to borrow additional funds in this country. The failure to remit dividends would result in a compounding of the foreign tax credit problem and would reduce U.S. tax revenue. The unremitted dividends would likely be invested by foreign subsidiaries, increasing the income taxed in foreign countries. The failure to receive dividends would cause the U.S. parent to borrow, further decreasing its U.S. taxable income. This increase in income taxed abroad and decrease in taxable income of related U.S. corporations would result in an increase in the amount of foreign taxes available for use and decrease in the foreign tax credit limitation, aggravating the problem.

For the foregoing reasons, we believe that the provisions of H.R. 3475 should be modified to allow the foreign tax credit the benefit of the three year carryback/fifteen year carryforward period, the FIFO ordering rules for utilization of the credit, and a mirror-image provision under section 904(f). These changes would serve the stated goals of conformity and simplicity and eliminate much of the inequity in this area of the Internal Revenue Code.

STATEMENT ON BEHALF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

TITLE VII—TAX COURT PROVISIONS

General Tax Court practice by CPA's

The AICPA is opposed to the proposed deletion of the last sentence of section 7452, as proposed by section 701(b) of H.R. 3475. Enactment of section 701(b) would result in the elimination of further admissions, by examination, of CPA's to practice before the Tax Court. It is another step toward conferring a legislatively advantaged position on law firm tax practice as against CPA firm tax practice. The important role of CPA's in representing clients in this forum has been recognized since the creation of the Board of Tax Appeals, the Tax Court's predecessor. To entirely eliminate this area of client representation and CPA practice seems to the AICPA to be an unnecessarily harsh solution to the perceived administrative problems and expense of the Tax Court examination.

Background

Prior to 1942, CPA's and lawyers were admitted on an equal footing to practice before the Board of Tax Appeals, the predecessor of the Tax Court. In 1942, the Board became the Court, the language which is now section 7452 became part of the law, and the Court adopted rules which admitted lawyers without examinations while requiring an examination of all others. Congress never decreed an exam be administered. Congress never indicated any unhappiness with CPA's as taxpayer representatives—nor did the Court.

The accounting profession, preoccupied with World War II, may have been asleep at the switch. It has since become more alert.

The Administrative Practices Act of 1965 originally would have allowed only lawyers automatic rights to practice before federal agencies—including the Internal Revenue Service. It was only the intervention of the AICPA that obtained for CPA's the same automatic right to practice before IRS as was conferred on lawyers. (The competitive significance of having a right under law to represent taxpayers in IRS disputes as compared to having only the privilege to do so conferrred by the IRS itself, is underscored in Judge Dawson's comments on the Small Tax Case representation provisions of this very bill. "We urge the Committee not to adopt legislation which would allow the commissioner of Internal Revenue, the adversary party to the litigation, in effect to control who is entitled to represent the small tax case taxpayer before the Tax Court.")

The issue of the third sentence of section 7452, we would thus suggest, is not really one of Tax Court practice at all. The implications of this or any other change will impact the availability of professional tax services to the U.S. taxpayer and the perception taxpayers have of the capabilities of CPA's as compared to lawyers. With the increasing number of lawyers interested in tax practice (membership of the American Bar Association Section of Taxation now exceeds 25,000), there are noises being made that again presage attempts by the Bar to limit the traditional scope of practice of CPA's. Despite the well recognized public benefit of CPA tax practice, the 1983–84 chairman of the Tax Section of the American Bar Association, Edward Delaney, was quoted in the August 1983 American Bar Association Journal, p. 1020, as wondering whether such CPA activities as "interpreting the law, counseling clients and representing them before administrative agencies—could not 'technically be unauthorized practice.' "

We believe that deletion of the third sentence of section 7452 will make it more likely that the furnishing of tax advice, the issuance of written provisions on tax questions for third party use, and the representation of taxpayers in controversies will ultimately be held to be solely the province of the lawyer. The CPA has been doing these things since the advent of the modern income tax seventy years ago. Person for person, the CPA is at least as qualified to do them as the lawyer. No one has ever alleged to the contrary. No one has cited any way in which the public interest would be served by restricting the federal tax practice rights of the CPA.

The sole stated reason for eliminating the "no qualified person" language from section 7452 is that few people pass the Tax Court exam and few petitions are filed by those who have. We would like to comment on these reasons, as well as propose some resource-saving alternative approaches the Tax Court could adopt without repealing the existing statutory language.

Why do few people pass the exam? An increasing percentage of the tax people in CPA firms have law degrees and are members of the Bar as well as being CPAs. They do not have to take the Tax Court exam. They appear on the Tax Court records as lawyers. To the extent that their firms allow them to practice before the Tax Court, however, it is because of the third sentence of section 7452. Eliminate that sentence and many, possibly all, CPA firms would prohibit such practice by their lawyer-CPA associates on the ground that it would then constitute an activity reserved only to persons practicing law—and CPA firms do *not* engage in what is clearly restricted to lawyers. Thus, for example, CPA firms do not presently allow their lawyer-CPA associates to practice in a U.S. District Court.

Further, the significance of being admitted to practice before any court is not measured solely by one's involvement in litigation before that court. The fact is that most lawyers admitted to practice before any court seldom, if ever, personally try cases before the court. The professional stature, the significance of tax opinions, etc. of one who has passed the tax Court exam is enhanced even if no case is ever docketed before the court. By administering an exam with a passage rate so far below that of the CPA exam, any state bar exam, or the IRS Special Enrollment exam, the Tax Court discourages many from undertaking the effort and expense of preparing for and taking the exam. The Committee might well challenge whether the present procedure really is not more a barrier to the "qualified person" rather than a guarantee of free access to practice before the Court. As a matter of equity, if the quality of practitioners before the Court is the reason for the exam, perhaps all professionals seeking such practice, including attorneys, should be subject to written examination.

The Court's concern over cost versus results could be alleviated by several alternative approaches, all apparently within its power to adopt with no added legislative action and without deletion of the third sentence of section 7452:

1. Hold the examination less often. The AICPA would support an exam every 3 or 4 years instead of annually.
2. Eliminate the examination, but provide that CPAs can practice before the Court if associated with an attorney admitted to practice before the Court, as many states do with out-of-state lawyers. We believe that much non-lawyer Tax Court practice is of this sort anyway, and the policy of at least some CPA firms requires such law firm association.
3. Increase the examination fee to cover more of the cost.

Conclusion

Elimination of the third sentence of section 7452 has significance far beyond the possible impact on the Tax Court budget. If such a step is to be taken, we urge that it happen in the context of a re-examination of the relative roles of the lawyer and CPS in tax practice. We would welcome hearings focussed on such a question in the context of professional competence, service to the taxpayer, and contribution to the maintenance of the integrity of our self-assessment system. Until then, we urge that this committee not disturb the professional balance of power.

Practice by CPA-attorneys

If the last sentence of section 7452 is to be eliminated, to protect the practice rights of CPA's who are also attorneys, but who practice accounting rather than law, the AICPA believes that the following language should be added, either as a new Code section, e.g. 7433, or as a substitute for the last sentence of the present Code section 7452:

> No person admitted to practice before the Tax Court shall be denied the right to practice before that court, or before any other court of the United States in federal tax matters, because of his or her failure to be a member of any profession or calling.
>
> Practice before the courts of the United States, including the Tax Court, in federal tax matters, shall be deemed to be the authorized practice of law and shall not be restricted by any state laws or rules relating to the unauthorized practice of law.
>
> Nothing contained herein shall be construed as to deny to the Tax Court, or to any other court, the right to make such rules and take such actions, including the suspension and disbarment of any person engaged in practice before it, as such court shall deem desirable.

Small Claims Tax Court Practice by CPA's

The AICPA believes that both the taxpayer and the Tax Court would be better served if CPAs were permitted to represent clients in the Small Claims division of the Tax Court, without examination. Where a CPA is already thoroughly familiar with the facts and issues, it is unfair to require the taxpayer to either represent himself or engage a second professional to represent him. The cost of introducing the second professional to the case is particularly burdensome where the amount in controversy is $5,000 or less, with the result that many taxpayers may be deterred from pursuing legitimate issues.

From the point of view of the Tax Court, the aid of the CPA to a taxpayer, who might otherwise represent himself rather than employ a second professional, will help expedite cases in an overburdened system. The CPA generally will be better able to present the relevant facts and issues in an organized and efficient manner. Congress has mandated simplified procedures for the Small Claims division, so the lack of a law degree should not be an issue. While the court presently allows CPA's and others to represent clients in small cases on an informal basis, many CPAs are unwilling to provide such service because of concerns about the propriety of such representation—and most taxpayers in small cases are unaware that they have any recourse except to appear for themselves or hire an attorney.

TITLE II—DOMESTIC RELATIONS

A year and a half ago, the AICPA's Federal Tax Division formed a Domestic Relations Tax Simplication Task Force. As you are aware, this Task Force has spent many hours trying to formulate solutions to the serious tax consequences that accrue to taxpayers solely by reason of their divorce. To this end the intent of the Task Force has been twofold; first, to simplify the current tax law and second, to achieve uniformity and certainty in federal tax results.

The AICPA is gratified to observe the culmination of the efforts of its Task Force as embodied in Title II of the "Tax Law Simplication and Improvement Act of 1983." This bill reflects the great strides that have been taken in order to simplify and improve the tax laws concerning domestic relations. There are, however, areas in the bill that require clarification. In addition, we would like to point out what we consider to be correlative changes that are required in order to be certain that all property transfers in connection with the divorce are treated uniformly throughout the Internal Revenue Code.

There are two definitions which are critical to the proper interpretation of sections of the bill, "cessation of marriage" and "property." We feel that both of these require more explanation. Additionally, the term "the marriage ceases" should be changed to "the final decree of divorce is entered" (or the equivalent thereof.)

We have found that certain subsections of the proposed legislation have been worded in an unintentionally restrictive fashion or may lack clarity. We feel the following situations warrant changes in either the statute or the legislative history: (1) section 1041(e)'s title and language should be changed from "Gifts Between Spouses" to "Transfers Between Spouses;" (2) section 71(b)(1)(A) should consider payments to third parties for the benefit of the payee; (3) section 71(b)(1)D) should incorporate the situation where payments are made shortly before the payor departs the payees household; (4) section 71(c) is a codification of the "Lester" case. The legislative history should indicate that the purpose of this subsection is to reiterate *Lester* v. *Commissioner;* (5) section 71(e) should not prohibit the divorced taxpayers from remarrying and filing joint returns with their new spouses; and (6) section 215(a)'s legislative history should make it clear that a deduction under the trust income tax rules would be available to a trustee, executor or other successor of a deceased payor if the successor is to continue the payments.

In reviewing the proposed legislation, we have noted three subsections whose further amendment would add greatly to the cause of simplification. Regarding the taxing of alimony or separate maintenance payments section 71(b)(1)(B) should be changed to allow the individuals to decide on the taxation of such payments by replacing it with the following: "the parties to the divorce or separation designate such payment as a payment which is includable in gross income under this section and allowable as a deduction under section 215." Additionally, we see no reason why one, lump-sum payment should not be accorded the tax treatment of alimony provided it meets all the other definitions of alimony. In this regard, we would recommend the deletion of section 71(b)(1)(F). Finally, where the custodial parent elects to release claim to an exemption under section 152(e)(2) such release should be binding for all subsequent years until amended or terminated by its owns terms. This would free the parties from the extreme burden of having to reach an agreement on a yearly basis.

As previously stated, certain correlative changes should be made to the following Code sections: 47(b)—Dispositions of Investment Credit Property, 453b—Transfers of Installment Obligations, 613A(c)(9)—Transfer of Oil or Gas Property. In addition, the Code should be amended to make it clear that the transfer of cash basis assets will not be deemed an "assignment of income" taxable to the transferor, but rather property covered by new section 1041. Further, it should be clear that any transfer of property subject to liabilities in excess of basis in connection with a divorce will not result in any current taxable event. Section 143(a)(2) also should be amended to incorporate section 71(b)(2)(C). Unless this were done the law regarding filing status would continue to preclude certain individuals from filing as single taxpayers where it seems appropriate. Finally, section 2516 should be amended to conform with the language of section 1041.

The AICPA appreciates the opportunity to present its position and hopes that its comments and suggestions will truly help Title II of H.R. 3475 live up to its name. We would be happy to respond to any questions you may have.

STATEMENT OF AMFAC, INC.

LITIGATION OVER THE ELIGIBILITY OF PROPERTY FOR THE INVESTMENT TAX CREDIT: THE STRUCTURAL COMPONENT ISSUE

Amfac, Inc. is a diversified company with significant operations in hotel services and department store retailing. It also has significant operations in agriculture and horticulture as well as in food processing and wholesaling. In the course of its operations, it has acquired considerable experience in the investment tax credit area. The company respectfully offers its comments on the investment tax credit.

The Committee on Ways and Means is currently reviewing proposals to revise the investment tax credit at-risk rules and a proposal to simplify the income tax credits. It is respectfully requested that the Committee also consider legislative rules to clarify the law and to reduce disputes on the definition of tangible personal property eligible for the investment tax credit. Specifically, it is urged that the Committee draft a rule defining structural components of a building which are not eligible as tangible personal property for the investment tax credit. Alternatively, the Committee might wish to clarify congressional intent in this area with suitable report language.

I. STATUTORY PROVISION AND PROBLEM

As first enacted in the Revenue Act of 1962, and as subsequently reinstated by the Revenue Act of 1971, the investment tax credit was established for "section 38 property." The Secretary of the Treasury or his delegate was authorized to prescribe regulations necessary to carry out the purpose of the investment tax credit. Section 48(a)(1) of the Internal Revenue Code of 1954, as amended, defines "Section 38 property" to mean among other things:

(A) tangible personal property (other than an air conditioning or heating unit), or,

(B) other tangible property (not including a building and its structural components) but only if such property;

(i) is used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communication, electrical energy, gas, water, or sewage disposal services.

Numerous tax audit controversies and considerable litigation have occurred over the inclusion or exclusion of property as "section 38 property." Furthermore, the courts as well as the Internal Revenue Service have used conflicting tests to determine if property is eligible as subclause (A) "tangible personal property." The confusion is increased, because in recent cases the test for an ineligible, inherently permanent structure on the land has been misapplied to ineligible structural components although the nature of a structural component is different from the nature of a structure.

II. THE TEST FOR INHERENTLY PERMANENT STRUCTURES ON THE LAND

Analysis at the outset is confused because subclause (A) "tangible personal property" is defined as "any tangible property" which is a term describing subclause (B) property. Despite the identical definition of subclause A "tangible personal property" and subclause (B) "other tangible property", these two catagories differ in two respects. First, subclause (B) "other tangible property" must be used in certain production operations or services; second, subclause (B) "other tangible property" excludes buildings and structural components but does include inherently permanent structures on the land. Subclause (A) "tangible personal property" is comparison excludes inherently permanent structures on the land as well as buildings and structual components. In addition subclause (A) "tangible personal property" need not be used in the production or service required for subclause (B) property. The lack of a use requirement and the exclusion of inherently permanent structures on the land are the only two distinctions that separate subclause (A) "tangible personal property" from subclause (B) "other tangible property".

These two distinctions are found in the legislative reports and the administrative regulations. The Ways and Means Committee in the report on the Revenue Act of 1962, House Report No. 1447, 87th Congress, 2d Session, reprinted in 1962-3 C.B. 515 and 516, states:

> Tangible personal property may qualify as Section 38 property irrespective of whether it is used as an integral part of manufacturing, production, or extraction or of the furnishing of transporation, communications, electrical energy, gas, water, or sewage disposal services. Local definitions will not be controlling for purposes of determining the meaning of the term 'tangible personal property.' For purposes of Section 48, the term 'tangible personal property' *includes any tangible property except land, and improvements thereto, such as buildings or other inherently permanent structures thereon* (including items which are structural components of such buildings or structures). Assets necessary to the operation of a business, such as machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, grocery counters, etc., generally constitute tangible personal property for purposes of Section 48 even though such assets may be termed as fixtures under local law. Further, assets in the nature of machinery will be considered 'tangible personal property' for purposes of Section 48 whether they are placed within or without a building or other structure. Thus, for example, a gasoline pump, or a hydraulic car lift, although not within any structure, will nonetheless be considered 'tangible personal property.' Intangible property, such as patents and copy rights does not quality as Section 38 property. [Emphasis added.]

An identical statement is found in the Senate Finance Committee report on the Revenue Act of 1962, Report No. 1881, 87th Congress, 2d Session, reprinted at 1962-3 C.B., Pages 858.

Parenthetically, it should be noted that the 1962 Revenue Act specifically excludes from eligible property, property which is used to furnish lodging or is used predominantly in connection with the furnishing of lodging. However, the act provided an exception for such lodging property when used by a hotel or motel in connection with the trade or business of furnishing lodging where the predominant portion of the accommodations is used by transients. Thus, items of tangible personal property used in the accommodations for lodging may qualify for the credit, if the property is used in a trade or business which fits under the hotel or motel provision. See House Report No. 1447, reprinted at 1962-3 C.B. 518 and 519, and Senate Report No. 1881, reprinted at 1962-3 C.B. 861.

In implementing the investment tax credit the Income Tax Regulations repeat the committees' definition of tangible personal property as any tangible property with the two distinctions. The regulations also expand on the exclusion of buildings and other inherently permanent structures with specific examples. Subsection 1.48-1(c) of the regulations states:

> *Definition of tangible personal property.* If property is tangible personal property it may qualify as Section 38 property irrespective of whether it is used as an integral part of an activity (or constitutes a research or storage facility used in connnection with such activity) specified in paragraph (a) of this section. Local law shall not be controlling for purposes of determining whether property is or is not 'tangible or personal.' Thus, the fact that under local law, property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, the term 'tangible personal property' means *any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures* (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges and fences, are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by Section 38. Further, all property which is in the nature of machinery, other than structural components of a building or other inherently permanent structures, shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property. [Emphasis added.]

Subclause (A) "tangible personal property thus is a broader category of eligible items than subclause (B) "other tangible property." The use requirement does not apply in subclause (A) and that category includes any tangible property. However, unlike subclause (B) subclause (A) does exclude "inherently permanent structures" on the land. Significant litigation has arisen over inclusion or exclusion of a property as an inherently permanent structure akin to a building on the land. Initially the Internal Revenue Service applied a "functional or equivalency" test to determine whether an item was the equivalent of or served the same function as an ineligible structure. Thus, for example, the Service in Rev. Rul. 67-67, 1967-1 C.B. 6, held a floating boat dock to be ineligible. A dock, the Service reasoned, is an inherently permanent structure and does not qualify as tangible personal property. The floating dock in this case was built in place of a "non-floating berthing facility annexed to the ground." Since the floating dock served the same function as a regular dock, the ruling concluded that it was an inherently permanent structure just like a stationary dock.

Shortly afterwards, the Tax Court in *Estate of Shirley Morgan*, 52 T.C. 478 (1969) rejected this ruling. The Court found that floating docks are readily removed, portable, and easily placed at other locations or in other configurations. The Court noted that annexation to the land does not automatically render the property an inherently permanent structure. Also, in this case, the floating docks were not affixed to the land but moored to the land with pilings.

The rationale for rejecting the functional test was not clearly enunciated in *Estate of Shirley Morgan*. It remained for other courts in the structural component area to outline the inadequacy of the functional test. See discussion in Part III. These other courts together with the Tax Court in *Morgan* did cause the Service to review the functional test; and in Rev. Rul. 75-178, 1975-1 C.B. 9, the Service abandoned this test as applied to inherently permanent structures. Instead, the Service focused on the manner of attachment and the permanency of attachment to the land, in determining whether property was inherently permanent like a building structure on the land.

Simultaneous with its re-assessment of the functional test, the Service was litigating several cases in which it had disallowed the investment tax credit for outdoor advertising signs; the Service contended that the signs were inherently permanent structures on the land. Reviewing one such case in *Whiteco Industries, Inc.*, 65 T.C. 664 (1975), the Tax Court developed further the concept of the property's manner of attachment and permanency of attachment to the land.

The Tax Court here devised a series of questions to determine if the signs were inherently permanent structures of tangible personal property; the Court asked:

(1) Is the property capable of being moved, and has it in fact been moved?
(2) Is the property designed or constructed to remain permanently in place?
(3) Are there circumstances which tend to show the expected or intended length or affixation, i.e., are there circumstances which show that the property may or will have to be moved?
(4) How substantial a job is removal of the property and how time-consuming is it?
(5) How much damage will the property sustain upon its removal?
(6) What is the manner of affixation of the property to the land?

The *Whiteco* questions were properly applied to determine whether items are like a building inherently and permanently affixed to the land, such as outdoor signs in that case, or grapevines in *Sidney Kimmelman*, 72 T.C. 294 (1979), or an electrical distribution system in *Scott Paper Company*, 74 T.C. 1371 (1980). These same questions, however, have been recently applied in the structural component area, and the results demonstrate the misapplication of the *Whiteco* test to structural components.

III. THE TEST FOR STRUCTURAL COMPONENTS

In its report on the Revenue Act of 1962, the Ways and Means Committee sought to define ineligible buildings and structural components in this manner:

> Buildings and structural components thereof are not eligible for the credit. The term 'building' is to be given its commonly accepted meaning, that is, a structure or edifice enclosing a space within its walls, and usually covered by a roof. It is the basic structure of an improvement to land the purpose of which is, for example, to provide shelter or housing or to provide working, office, display or sales space. The term would include, for example, the basic structure used as a factory, office building, warehouse, theater, railway or bus station, gymnasium, or club house. The term 'structural components' of a building includes such parts of the building as central air-conditioning and heating systems, plumbing, electrical wiring and lighting fixtures, relating to the operation and maintenance of the building.

House Report No. 1447, reprinted in 1962-3 C.B. 516. Identical language is found in Senate Report No. 1881, reprinted in 1962-3 C.B. 858 section 859.

Section 1.48-1(e) of the regulations repeats the committee report's definition of "building"; and section 1.48-1(e)(2) of the regulations expands on the report in defining "structural components" of buildings:

> The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs; escalators, and elevators, including all components thereof; sprinkler systems; fire escapes, and other components relating to the operation or maintenance of a building.

In 1964, the Congress found that this regulation did not accurately reflect congressional intent in excluding escalators and elevators as structural components; and in Public Law 88-272, the Congress specifically provided that escalators and elevators would be eligible for the investment tax credit as "Section 38 property."

It should be stressed that even if an item is incorporated during construction so as to be an integral part of the building, it is not a structural component where it does not relate to the building's operation or maintenance. If an item relates instead to the business conducted in the building, it is not a structural component. The Tax Court in *Scott Paper Company,* 74 T.C. 137, 182 & 183 (1980), thus noted that section 1.48-1(e)(2) of the regulations deems electric wiring to be a structural component only if the wiring relates to the operation and maintenance of the building. In that case, a portion of the wiring related to the building's operation and was held to be a structural component. But a more significant part of the wiring related to the paper pulp-making business being conducted in the building and to that extent the wiring was not a structural component; rather, the wiring was eligible tangible personal property.

Persistent litigation has still occurred over the definition of the term "structural component" of a building. The litigation has been fostered by inconsistent tests applied by the Internal Revenue Service and the courts as well as by the misapplication of the inherently permanent structure test to structural components.

For example, the Internal Revenue Service in Rev. Rul. 69-14, 1969-1 C.B. 26, initially held that movable partitions, whether ceiling or bank height, installed in an office building did not qualify as "Section 38 property." In this ruling the Service applied the same "functional or equivalency test" which had been earlier applied to the floating boat dock. In this subsequent ruling, the Service determined that the partitions served a function essentially the same as a permanent wall or permanent partition in subdividing the working area of an office building. Thus, the movable partitions were determined by the Service to be structural components of the building.

The Eighth Circuit Court of Appeals and the Tenth Circuit Court of Appeals in *Minot Federal Savings and Loan Association* v. *United States,* 27 AFTR2d 71-334 (1970), and in *King Radio Corporation, Inc.* v. *United States,* 32 AFTR2d 73-6044 (1973), respectively, rejected the functional test. In both these cases, the Service, utilizing the functional test, had again argued that the movable partitions served the same function as a wall and therefore the partitions constituted a structural component of the building. The Eighth Circuit in response stated that neither the statute nor the regulation suggests or requires any functional or equivalency test. Furthermore, the Court noted the Service's own rulings contradicted the functional test, since the Service had ruled that vault doors and walk-up and drive-up bank teller windows—although the equivalent of doors, walls, and windows—were not structural components of a building, since their removal would not affect the continued operation of the bank building.

The Tenth Circuit in *King Radio Corporation,* in rejecting the functional test, drew particular attention to the fact that section 1.48-1(e) of the regulation in defining structural components, refers to parts of a building and lists as examples a series of items that are integrated with the building during the construction phase. These are walls, partitions, floors and ceilings. The Court also pointed to the Technical Explanation found in the congressional reports on the Revenue Act of 1962. As the Court noted, the reports list as structural components, items which are permanent in the sense that they are incorporated in the building during construction, such as central air-conditioning and heating systems and plumbing needed for the building's operation.

If the item in question is not an integral part of the building incorporated during construction, the *King Radio Corporation* analysis then turns to whether the item is a permanent covering of any part of the building; that is whether the item is a permanent covering of the building's walls, floors, or ceilings. The Tenth Circuit here just as the Eighth Circuit in *Minot,* found support for its analysis in various Service rulings which had held that wall-to-wall carpeting was not a permanent part of the floor and that a bank's vault doors, walk-up and drive-up teller windows were not a permanent part of the bank building although they were attached to the bank structure.

The analysis in the *King Radio Corporation* decision undertook a two part discussion. The Court first needed to determine whether the item in question was an integral part of the building structure, such as a floor or wall or beams or girders or plumbing. Such items as sinks, central air conditioning or heating machinery, even doors and windows, are removable; but they are structural components, because they are incorporated during construction to become integral parts of the building and relate to the building's operation and maintenance. If the item were not incorporated into the building structure during construction, the Court then asked whether the item was a permanent covering for any part of the building structure; on this second question, the Court needed to determine the permanency with which the structural covering was affixed to the structural part. This analysis supplanted the Service's functional or equivalency test.

With these and other reversals, the Service reviewed its position in Rev. Rul. 75-178, 1975-1 C.B. 9. This ruling, as stated earlier in Part II, revoked the functional test in determining whether an item was a building or an inherently permanent structure. The ruling also revoked the functional test in determining whether an item was a structural component of a building. With regard to the structural component analysis, the ruling noted:

> The use of a functional or equivalency test . . . to classify property as a structural component where it is not an integral part of (and therefore a permanent part of) a building, is no longer the criteria to be used to classify property. Rather, the problem of classification of property as 'personal' or 'inherently permanent' should be made on the basis of the manner of attachment to the . . . structure and how permanently the property is designed to remain in place.

It is to be noted that the revenue ruling restated the two-part analysis in *King Radio Corporation.* The ruling first considers whether an item is an integral part of a building; that is, in the language of *King Radio Corporation,* whether an item is an integral part of the building incorporated during construction and related to the building's operation or maintenance. If an item is not an integral part of the building, the ruling then considers the means and permanency of attachment to the building. In other words, the ruling would then apply the test for inherently permanent structures to structural components.

On this point, the ruling went beyond the *King Radio Corporation* decision, in focusing on the means by which a non-integral item is atatched to the structure and on the permanency of the attachment to the structure; the *King Radio Corporation* decision had talked only of a non-integral item being considered a structural component if it served as a permanent covering of a structural item such as a ceiling or wall. Examples of a permanent covering would be panelling or tiling.

The analysis in Rev. Rul. 75-178 would include as structural components, fixtures which are not an integral part of the building structure and not a permanent covering of a structural item; under the ruling, the means and permanency of the fixture's attachment to the structure would determine whether the item was a structural component. Under this analysis, previously sanctioned items—vault door, and walk-up and drive-up bank teller windows, Rev. Rul. 65-79, 1965-1 C.B. 26; stadium seats, backstops, flag poles mounted on the stadium and the equipment and circuitry contained in or attached to the scoreboard and the message boards, Rev. Rul.69-170, 1969-1 C.B. 28—would be structural components, since they are permanently affixed to the underlying structure and removal would be difficult. Conversely, items that are structural components under the regulation—central air conditioning motors and compressors even lighting fixtures—should not be considered structural components, because the means of attachment is far from permanent and because the items are easily removable.

Permanency of attachment or the obverse concept of removability is not an adequate test when applied to fixtures. The statute, the congressional reports, and regulation clearly envisioned that fixtures would be treated as tangible personal property under subclause (A) of section 48(a)(1), provided the fixture were not a structural component. The regulation in enumerating structural components indicated, as *King Radio Corporation* noted, that fixtures would not be eligible if they were an integral part of the building incorporated at the time of construction for the necessary operation and maintenance of the building. The court in *King Radio Corporation* adopted the permanency test only to determine if a covering of a structural part was so affixed to that structural part as to be a structural component. If the removability or permanency test is applied to all fixtures it leads to results contrary to past authority. See, for example, the application of this test to a fire detection system which included sensors, elevator recall mechanisms, door unlocking mechanisms, loudspeaker system, and computer, where all items were held to be structural components; Rev. Rul. 77-362, 1977-2 C.B. 8. The ruling looked at the manner and permanency of the system's attachment to the structure and found the system including the computer to be designed to remain in place permanently.

In the Revenue Act of 1978, the Senate Finance Committee sought to clarify the definition of structural components with various examples in its report accompanying the legislation. Under the Act, the Congress made permanent the 10 percent investment tax credit and the $100,000 limitation on used property; the Congress also increased the limitation of the investment tax credit to 90 percent of tax liability and increased the credit for pollution control facilities. The investment credit was also established for single purpose agricultural or horticultural structures and for certain rehabilitated structures. The investment tax credit was also fully extended to cooperatives. In the context of this review, the Senate Finance Committee recited a list of items not deemed structural components under present law. Senate Report No. 95-1263, 95th Congress, 2d Session, reprinted at 1978-3 C.B. 415.

> In addition, the Committee wishes to clarify present law by stating that tangible personal property already eligible for the investment tax credit includes special lighting (including lighting to illuminate the exterior of a building or a store, but not lighting to illuminate parking areas) false balconies and other exterior ornamentation that have no more than an incidental relationship to the operation or maintenance of a building, and identity symbols that identify or relate to a particular retail establishment or restaurant such as special materials attached to the exterior or interior of a building or store and signs (other than billboards). Similarly, floor coverings which are not an integral part of the floor itself such as floor tile generally installed in a manner to be readily removed (that is it is not cemented, mudded, or otherwise permanently affixed to the building floor, but, instead has adhesives applied which are designed to ease its removal), carpeting, wall panel inserts such as those designed to contain condiments or to serve as a framing for pictures of the products of a retail establishment, beverage bars, ornamental fixtures (such as coats-of-arms), artifacts (if depreciable), booths for seating, movable and removable partitions, and large and small pictures of scenery, persons and the like which are attached to walls or suspended from the ceiling, are considered tangible personal property and not structural components. Consequently, under existing law, this property is already eligible for the investment tax credit.

This committee clarification was repeated in the General Explanation of the Revenue Act of 1978, prepared by the staff of the Joint Committee on Taxation.

IV. APPLICATION OF THE INHERENTLY PERMANENT STRUCTURE TEST TO STRUCTURAL COMPONENTS

Despite these administrative, judicial, and legislative attempts to clarify the definition of structural components, confusion has increased because of Rev. Rul. 75-178 and recent holdings. In *Consolidated Freightways, Inc. & Affiliates* v. *Comm'r.*, 52 AFTR 2d 83-5328 (9th Cir. 1983), the Court of Appeals used the *Whiteco* multi-factor test for inherently permanent structures to determine whether overhead doors and lighting fixtures on a truck loading dock were structural components.

The Ninth Circuit in *Consolidated Freightways, Inc.* ignored the two-part test for structural components devised in the *King Radio Corporation* decision which first inquires whether the item is an integral part of the structure which was incorporated in the building during construction and which relates to the building's operation. This test would have held the overhead doors and lighting fixtures to be structural components, since they are integral parts of the structure incorporated during construction.

Instead, the Ninth Circuit in *Consolidated Freightways* seized on the second part of the *King Radio Corporation* test and misconstrued it. As earlier stated, *King Radio Corporation* applied the permanency test to items which covered structural parts and which were not integral to the structure and not incorporated in the structure during the time of construction for the building's operation. The permanency test was used to determine in such an item was permanently affixed. But *Consolidated Freightways* misconstrued the test to ask whether the fixture item is removable and it misapplied its interpretation of the test to integral parts of the structure—doors and lighting fixtures which by their nature are removable. The Court thus found the permanency test to be inadequate in this context.

Although the Ninth Circuit casted about for a new standard, it simply expanded on the permanency factor in applying the *Whiteco* questions to structural components. The Court looked at the function and design of the component, the taxpayer's intention in installing the component, and the effect on the building of removing the component. The Court thus found that the overhead doors and lights were intended to be a permanent part of the docks and therefore ineligible.

Although applied in *Consolidated Freightways* to structural components, the *Whiteco* test as stated in Part II was devised not to evaluate structural components but rather to evaluate inherently permanent structures on the land. The *Whiteco* test sought to determine if the outdoor advertising signs were ineligible for the investment tax credit as inherently permanent structures akin to a building structure affixed to the land.

The *Whiteco* analysis for inherently permanent structures similar to buildings is not applicable to structural components. It interjects unnecessary complexity in an area already prone to litigation and creates an improper test for structural components. Under the multi-factor *Whiteco* decision, items which the Service had previously held to be tangible personal property would need to be re-catagorized as structural components. Similarly, items which are structural components under the regulation would need to be re-catagorized as tangible personal property.

Furthermore, in two recent private letter rulings, the Service has created additional confusion and provided no guidelines to determine whether an item is a structural component. Had the rulings applied the first part of the *King Radio Corporation* test, to determine whether the items in question were integral parts of the structure incorporated at the time of construction and relating to the structure's operation, the correct results would have been achieved. However, this first part of the test was ignored, and the two rulings focused on the removability of the items. Indeed, both rulings looked to whether the items were "inherently permanent," which is a test to be applied in determining whether an item is a structure akin to a building on the land.

In applying this permanency test, neither ruling found a satisfactory rationale for their conclusion. LTR. 8102012 held that suspended or "false ceilings" were structural components, because the brackets were infrequently moved. LTR. 8002015 held that a restaurant interior decorative lighting was a structural component because it is spliced into the electrical system. The strained conclusion under the permanency test however required both letter rulings to reject movability as the sole test of whether an item is a structural component and no alternative test was given.

Moreover, LTR. 8002015 rejected the congressional attempt to clarify the investment tax credit in the Revenue Act of 1978. The ruling specifically stated that the congressional report language provided no aid to statutory construction, since the clarification occurred sixteen years after the establishment of the investment tax credit. On this point, the Tax Court in *United Telecommunications, Inc.*, treated committee report language in the Tax Reduction Act of 1975 only as "a secondarily authoritative expression of expert opinion;" for the views of a subsequent Congress on the investment tax credit is a hazardous basis for inferring the intent of an earlier one. 65 T.C. 278, 287 (1975).

V. REQUEST FOR LEGISLATIVE CLARIFICATION

In view of the present confusion, it is respectully requested that the committee during its consideration of the Tax Law simplification and Improvement Act of 1983 clarify the definition of tangible personal property eligible for the credit. In particular, the Committee needs to clarify the definition of structural components which are ineligible for the credit. It is suggested that the Committee re-affirm the structural component test so as to be completely separate from the test applicable to determining whether an item is a structure akin to a building on the land; it is respectfully urged that the Committee codify the two-part test formulated in the *King Radio Corporation* decision.

STATEMENT OF LAW FIRM OF ARNOLD & PORTER PRESENTED BY JOSEPH H. GUTTENTAG AND STANFORD G. ROSS

Section 501 of H.R. 3475, the Tax Law Simplification and Improvement Act of 1983, contains a proposed definition of "resident alien." This definition, if enacted, would be the first considered legislative change in this area of the income tax law since its inception. Thus, this section deals with an issue of major importance and every effort should be made to provide a thorough and considered resolution to the many tax policy issues that turn on this definition.

Our law firm represents a variety of clients potentially affected by these provisions. We advise alien individuals who come to the United States, foreign corporations that send alien individuals to the United States, and United States corporations and international organizations that employ, or engage as consultants, alien individuals. In addition, members of our firm have served in tax policy positions in the Treasury Department and have dealt with these issues from the government's point of view. Most importantly, members of our law firm have dealt with these issues as a public interest matter and participated in various bar association and other law reform activities concerning this subject. Therefore, we submit our comments based on this extensive experience and background to further the public interest in resolving to the maximum extent possible the important tax policy issues involved in the tax law definition of "resident alien."

IN GENERAL

We commend the Committee on its efforts to provide a simpler and improved scheme for categorizing residents or nonresidents for Federal income tax purposes. We believe the bill is moving in the right direction by attempting to inject as much objectivity and certainty as possible into an area of the tax law that until now has largely turned on subjective determinations.

The bill, however, falls short of its goals of simplification and improvement in several major respects. First, serious definitional problems continue to exist in: (1) the substantial presence test; (2) the closer connections exception; (3) the exempt individuals category. Also, there is a failure to consider transitional rules and the indirect consequences of classification as a resident or nonresident alien. Thus, we would strongly urge that substantial additional technical work is necessary before the bill is ready for passage by the Ways and Means Committee.

We would note that it can be advantageous or disadvantageous for either the government or the alien individual to be classified or not to be classified as a resident or nonresident. Depending on the alien individual's income and deductions, as well as, if he is married, the tax status of his spouse and her income and deductions, it may raise or lower taxes to be classified in one category or the other. Thus, what is primarily involved is establishing objective and understandable provisions that can apply fairly so that compliance by the Internal Revenue Service can be more even-handed. We do not believe that there are major revenue considerations for slanting the definition in one direction or another. Tax policy in this area should basically reflect equity considerations.

THE BASIC TEST BASED ON DAYS IN THE UNITED STATES IS TOO COMPLICATED AND HARD TO UNDERSTAND

Present law in most instances provides no objective test for ascertaining when a alien individual is or is not a resident of the United States. The lack of an objective test makes it very difficult for alien individuals to make both personal and employment-related plans. The proposed definition of "resident alien" contained in Section 501 attempts to correct the deficiencies of present law by creating objective criteria for residency based on an individual's immigration status and length of stay in the United States. The proposed criteria, however, fail as an objective test because they set out an overly elaborate scheme for determining what constitutes residence. We believe the result is too complicated and will be hard for alien individuals to understand and comply with.

The use of a weighted sum of the days on which an individual is present in the United States in the current year and the preceding two years is very complicated to apply and as a practical matter will not provide an understandable basic test. Under the proposed test, it is not possible to advise a foreigner as to the maximum permitted length of the stay in any given year without knowing not only the duration of his visits to the United States in past years, but also his plans as to visits to the United States in the future. Thus, this weighted sum does not provide the certainty and objectivity that is so needed in this area of the tax law. Therefore, we would recommend a simpler basic test for substantial presence, one that is based solely on presence in the United States in the taxable year at issue.

Many countries use a 183-day test. The United States presently uses the 183-day test for capital gains taxation of aliens. If this test is considered too permissive, then a 92-day rule or a 61-day rule could be considered. But the result should be a simple and easy to understand basic rule before more complicated criteria are provided to deal with situations that require consideration of other criteria than days in the United States in the current year.

THE SUBSTANTIAL PRESENCE TEST IS TOO COMPLICATED AND UNCERTAIN OF APPLICATION

As the bill is currently written, there is one exception to the substantial presence test. If an individual has been in the United States less than 183 days, that individual has one other avenue of establishing nonresident alien status. The substantial presence test does *not* apply when two things are established: (1) the individual was present in the United States for fewer than 183 days in the current year; and (2) in the current year the individual has a tax home in a foreign country and a closer connection to such country than to the United States. Both of these concepts are fraught with uncertainty and will be difficult to apply to particular situations.

The proposed provision states that the term "tax home" is used as it is defined in Section 911(d)(3). Section 911(d)(3) defines tax home as an individual's home "for purposes of section 162(a)(2)," with the additional provision that an individual cannot have a tax home in a foreign country for any period in which his abode is within the United States. Under section 162(a)(2), after many years of controversy, case law and revenue rulings have established, in most jurisdictions, that an individual's tax home is his "regular or principal place of business." Therefore, an individual who attempts to apply the closer connections exception must make three complicated factual determinations: (1) whether he has a "regular or principal place of business" in a foreign country; (2) whether he does not have "an abode" within the United states; and (3) whether he has "closer connections" to the foreign country. All three of these factual determinations are very similar, indeed identical in some circumstances, to at least a portion of what a taxpayer would have to prove under current law to establish his lack of intent to be a U.S. resident.

The "closer connections" exception all by itself is rife with ambiguity and uncertainty. It raises the specter of the same kinds of confusion present under existing law. Therefore, the inclusion of the closer connections test in the proposed law results in what is essentially a return to the problems currently plaguing existing law: the need for complicated and lengthy examinations of the particular facts and circumstances of each alien's situation.

Looking at the issue as a practical matter, classification of an individual who meets the substantial presence test but has not spent 183 days in the United States in the year at issue is not made simpler under the proposed law. Such classification continues, essentially, to be subject to the same kind of uncertain principles as under current law. Only those individuals on either extreme of the substantial presence test—those who stay in the United States more than 183 days in any given year or those who do not stay in the United States long enough over any three-year period to meet the 183-day weighted sum requirement—will gain certainty from the new law: those individuals and only those individuals will be subject to an objective test of resident alien status.

THE PERMANENT RESIDENCE TEST INTRODUCES A NEW AND UNCERTAIN CONCEPT INTO THE TAX LAW

The proposed bill creates at least one new area of difficulty. The exemption created for foreign government-related individuals, teachers, and students applies to all such individuals unless the facts and circumstances indicate that such individual intends to "permanently reside in the United States." Thus, any individual who otherwise qualifies for exemption is still subject to a subjective intent test, the difficulties of which are all too evident in existing case law. Moreover, this exemption creates a new standard that is ambiguous and uncertain. What does it mean that an individual intends to reside "permanently"?

Is permanently equivalent to "indefinitely," one of the criteria under present law? Does "permanently" require an individual to have an immigration status such that he or she can stay in the United States for as long as he or she wants after employment terminates? Or does "permanently" mean something more equivalent to "domicile"? Is it a comparative test so that an individual's continuing connections to and intention to return to a foreign country are taken into account? Once again, by utilizing vague wording and undefined terminology, the proposed law recreates the very problem it is attempting to solve. There is nothing to be gained by overturning existing case law in favor of undefined and uncertain standards that in turn must be the subject of litigation before their true meaning is knowable.

INDIRECT CONSEQUENCES OF CLASSIFICATION AS A RESIDENT OR NONRESIDENT OF THE UNITED STATES NEED TO BE CONSIDERED

Substantial indirect consequences often result from classification of an alien as a resident or nonresident of the United States. Thus, provisions such as the foreign personal holding company provisions or the controlled foreign corporation provisions may be invoked. The bill does not address these indirect consequences and consideration should be given to incorporating a rule that only invokes these provisions if an alien is a resident in the United States for 3 consecutive years. This transition period would give aliens an opportunity to reorganize their affairs without the imposition of unexpected tax penalties.

Similarly, U.S. tax law presently contains no provisions with respect to the tax consequences generally of moving from a resident to nonresident status or a nonresident to resident status. Section 877 deals in certain circumstances with citizens who expatriate, but this provision, which has limited application, only serves to highlight the inadequacies of present tax law in this area. Some other countries do deal directly with both entry and departure aspects of an alien's tax situation, and it would be desirable if the United States developed an explicit statutory scheme to deal with these matters. While the issues here are not simple ones, it is important that they be resolved to the maximum extent possible. This bill would seem an opportune time for consideration of these secondary aspects of classification issues.

TRANSITION RULES NEED TO BE PROVIDED

Section 501(b) makes the provisions of the bill effective for "taxable years beginning after December 31, 1983." Assuming that the law is changed to take into account days present in the United States in preceding years, it will be necessary to address the issue of whether this provision applies retroactively to include years prior to enactment of the legislation. Other transition issues of this type might be raised by other aspects of the bill. It could be necessary to make special provision for the fact that alien individuals may not have maintained the records necessary for retroactive application of these tests. In sum, it could be that some sort of moratorium or postponed application of the new tests should be provided for a period, say two or three years, to provide aliens an opportunity to learn about an understand how to comply with the changes.

THE PROPOSED BILL REQUIRES SUBSTANTIAL CHANGE IF IT IS TO ACHIEVE ITS GOALS OF SIMPLIFICATION AND IMPROVEMENT OF THE TAX LAW

In conclusion, we strongly urge the Committee to simplify, clarify and improve section 501 of "The Tax Law Simplification and Improvement Act of 1983." The goal of creating certainty and equity in the area of resident alien status and taxation is a worthy one. The bill as presently written is a useful start but does not go far enough towards reaching that goal. Considerable additional work is needed to provide a true resolution of the many difficulties that have plagued this area of the tax law for so many years. We would be happy to cooperate with the Committee to this end.

ARTHUR ANDERSEN & CO.,
Washington, D.C., July 29, 1983.

Re: Comments on H.R. 3475, Proposed "Tax Law Simplification and Improvement Act of 1983."

Hon. DANIEL ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: We are pleased to have the opportunity to provide our comments on this proposed legislation. In general, we think the proposal achieves the stated goal of providing improvements and simplifications with respect to the matters addressed. There are, however, several aspects of the Bill—primarily technical points—that we wish to call to your attention, as summarized in the remaining paragraphs of this letter. The enclosed memorandum provides more detailed discussions (with examples where appropriate) of these comments.

Individual Estimated Tax Revisions (Title I).—The proposal, which would effectively combine and coordinate several Code sections, is a definite step in the proper direction. However, we believe the proposed new wording of Section 6654 could be greatly simplified, while still accomplishing what we understand to be the objective of the proposal. More specifically, the "recapture" language introduced into this section (proposed Section 6654(d)(2)(ii)) is overly complex, and we propose a more simplified approach, as outlined in the attached memorandum. But if the recapture provisions are ultimately deemed necessary, we suggest clarifying proposed Section 6654(d)(2)(ii) to make clear that the amount of the "reduction" referred to in that clause is determined without regard to any recapture. This would avoid a doubling-up or compounding effect of the recapture that could occur under the present Bill.

Also, in view of the lack of statutory, administrative and judicial guidance on how to make calculations under the annualized income rules, we urge that any legislation on estimated tax should direct Treasury to issue regulations on the annualized income rules as soon as possible.

Domestic Relations (Title II).—The Bill would significantly improve and clarify domestic relations tax concepts. We believe, however, that the proposal to treat all property transfers between former spouses within one year after their divorce as being incident to the divorce is too broad and should be amended to be a *rebuttable* presumption. Also, we think the Bill should provide that any increases in alimony pursuant to a modified separation agreement will be recognized for income tax purposes if both parties sign the agreement and attach a copy thereof to their income tax returns.

Revision of At-Risk Rules for the Investment Credit (Title III).—The proposal would eliminate many of the ambiguties and uncertainties in existing law, particularly for partnerships and S corporations. As more fully detailed in the enclosed memorandum, we recommend changes to clarify the treatment of property acquired without borrowing, to make the restrictions on recourse borrowing from a related person more equitable, to provide the same treatment for a limited partner as that for a shareholder of an S corporation with respect to certain recouse financing, to eliminate the "three-employee requirement" for an active trade or business, and to permit inclusion of recourse seller financing in the credit base in arms-length transactions. We believe these changes would be consistent with the overall purpose of the proposal, without generating opportunities for abuse.

Simplification of Tax Credits (Title VIII).—Under present law, the research credit is subject to a limitation in that it is available only when qualifying expenditures are incremental (i.e., in excess of average expenditures for a base period). The Bill would further limit use of the research credit by combing it with other business credits into a General Business Credit that is subject to an overall limitation. We think it may be inappropriate, in the name of simplification, to further impair use of this important incentive provision that Congress enacted just two years ago.

We would be happy to answer any questions on these comments or provide further information upon request. Please contact the undersigned at 862-3368 if you would like to discuss this matter.

Very truly yours,

BYRLE M. ABBIN,
Managing Director, Office of Federal Tax Services.

Enclosure.

H.R. 3475 TAX LAW SIMPLIFICATION AND IMPROVEMENT ACT OF 1983, COMMENTS SUBMITTED BY ARTHUR ANDERSEN & CO., JULY 29, 1983

TITLE I—REVISION AND SIMPLIFICATION OF ESTIMATED INCOME TAX FOR INDIVIDUALS

As stated in the "Technical Explanation of HR 3475", Title I of the bill is intended to simplify, clarify and consolidate the estimated tax provisions for individuals. We believe the bill substantially achieves these goals and established much more streamlined rules in this area. In general, we agree with the concepts and rational behind the proposals. However, we believe several revisions are needed, primarily with respect to the use of annualized income in determining the amount of a required estimated tax installment.

Determination of "required installments"

Proposed Section 6654(d) contains a rather complex definition of the amount of an individual's "required installments". The recapture rules that would apply when payments are based on annualized income are language would be substantially revised. Proposed Section 6654(d)(2)(A) interpreted to produce an unintended result.

Recapture rules.—The bill would essentially leave intact the current law provision (Section 6654(d)(2)) permitting payments based on annualization of taxable income for interim periods, but the statutory especially intricate and, under certain circumstances, could be provides that if the annualized income amount is lower than the amount based on the current or prior year's tax, then the annualized income amount becomes (is) the required installment.

For example, if an individual's current-year tax is $150,000 and his prior year's tax was $100,000, he would have a "tentative" required installment for April 15 of $25,000, which is the lesser of (a) 25 percent x 80 percent x $150,000 or (b) 25 percent x $100,000. If he can show that 25 percent of 80 percent of his tax on annualized income for the period January 1 through March 31 of the current year is $20,000, that lower amount of $20,000 would be his April 15 required installment.

For any installment, if the "tentative" required installment exceeds the annualized income amount, this "reduction" (as it is referred to in the Bill) must be recaptured by adding it to the "tentative" required installment for the next installment due date; and to the extent such reduction is not recaptured in that payment, it must be added to the "tentative" required installment for subsequent due dates until fully recaptured.

Thus, in the above example, the "reduction" of $5,000 (i.e., $25,000 minus $20,000) in the April 15 installment would produce a "tentative" required installment of

$30,000 for July 15. This $30,000 amount would then be compared to 50 percent of 80 percent of the tax on annualized income for the period January 1 through June 30, minus the sum of prior required installments. If 50 percent of 80 percent of the tax on annualized income is, say, $40,000, the required installment for July 15 would be $20,000 (i.e., $40,000 minus the $20,000 April 15 required installment), since this is less than $30,000.

At this point, assuming that compounding of recapture (discussed below) does not apply, the potential recapture for subsequent installments is $10,000 (i.e., the $5,000 reduction from April 15 that was not recaptured on July 15, plus the $5,000 reduction arising on July 15). Thus, the "tentative" required installment is $35,000 for September 15. If 75 percent of 80 percent of the tax on annualized income from January 1 though August 31 is $90,000, the annualized income amount would be $50,000 (i.e., $90,000 less the total of the prior two required installments—$40,000). Therefore, the September 15 required installment would be $35,000 (i.e., the lower of the "tentative" required installment or the annualized income amount), and no potential recapture would exist to be carried to the January 15 installment.

We think this relatively intricate arithmetical exercise, required by proposed Section 6654(d)(2)(A)(ii), is unnecessary and contravenes an objective of simplification. No "recapture" language is required. We believe a much more simplified approach could be drafted to achieve the desired results. Basically, this could be accomplished be defining the term "required installment" as:

(1) The "applicable percentage" multiplied by the lowest of: (a) the prior year's tax; (b) 80 percent of the current year's tax; or (c) 80 percent of the tax on annualized income for months in the current year ending before the installment due date; minus

(2) The sum of the required installments for the prior installment due dates.

The "applicable percentage" referred to above would be 25, 50, 75, and 100 percent, respectively, for the installments due April 15, July 15, September 15 and January 15.

The table attached as Exhibit I illustrates this simpler approach in graphic format.

Our suggested approach produces the same required installment amounts as under the more complex proposed statute; under the facts the above example, both methods result in required installments of $20,000, $20,000, $35,000 and $25,000, respectively. We believe this approach will always provide the results desired by the drafters of the bill, but in a much more simplified manner.

NOTE.—The above comments (and Exhibit I) assume that the bill as ultimately enacted will eliminate the existing "safeguard" exception based on the prior year's facts and the current year's rates. In its July 25, 1983 testimony on the bill, treasury stated it favors retaining this safeguard, as do we. If it is retained, it could be easily incorporated into the simplified approach outlined above. The only modification needed would be to define the "required installment" in terms of the lowest of four amounts—the three mentioned above plus the tax based on the prior year's tax and the current year's rates.

Potential compounding of recapture.—As presently drafted, proposed Section 6654(d)(2)(A)(ii) can be interpreted to require an unintended compounding of recapture, which should be corrected if our suggestion to use a more simplified statutory approach is not adopted. To illustrate the potential compounding, in the above example the $5,000 reduction in the April 15 installment must be added to the $25,000 "tentative" required installment for July 15. So far, so good. However, the proposed statute appears to provide that the resulting total ($30,000) is to be used not only in determining the required installment for July 15 but also in determining the amount of any "reduction" arising in that installment to be added to the September 15 installment. This would result in a $10,000 "reduction" in the July 15 installment (i.e., $30,000—$20,000), which would produce a "tentative" required installment of $40,000 for September 15. Under this interpretation of the bill, the April 15 reduction would be recaptured twice on September 15—once as part of the reduction from the July 15 installment and a second time as an unrecaptured reduction from the April 15 installment.

This potential compounding of recapture must certainly be unintended. Thus, if the proposed statutory rules are not simplified as suggested earlier, we believe proposed Section 6654(d)(2)(A)(ii) should be clarified by specifying that the "reduction" for any installment is determined before that installment is increased by a "reduction" from any prior installment. (In the example, only a total potential recapture of $10,000—not $15,000—should be added to the $25,000 "tentative" required installment for September 15.)

Need for more specific regulations on the annualization concept

The major problem for taxpayers using the income annualization rules has traditionally been determining interim period taxable income and the tax (after credits) on annualized income. Proposed Section 6654(d)(2)(C)(i) carries over the present statutory language providing that taxable income should be annualized in accordance with Treasury regulations. Unfortunately, the present regulations (Reg. 1.6654-2(d)) contain very little guidance concerning how the annualization calculations are to be made. Many problems of interpretation apply in the case of individuals using annualization as the basis for their estimated tax payments. (Moreover, the principles of annualization are now much more important for corporations due to the "large" corporation rules under Section 6655.) Therefore, we submit that it may be appropriate for this Bill to include a mandate to Treasury to issue more specific regulations governing the annualization determinations as soon as possible.

TITLE II—DOMESTIC RELATIONS

Property settlements

The "Technical Explanation of HR 3475" provides several reasons for the revisions contained in Section 202 of the bill. One reason is to reverse the U.S. Supreme Court's decision in *United States* v. *Davis*, 370 U.S. 65 (1962), which held that a property transfer incident to a divorce is a taxable transfer. The *Davis* result is not compatible with either the tax rules concerning equal division of community property or the IRS rule on the partition of jointly held property. Section 202 of the Bill would make changes designed to harmonize the various treatments of the transfer of property between spouses while married or incident to a divorce.

Proposed new Section 1041(a) would provide a general rule that no gain or loss would be recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or to a former spouse if the transfer is incident to divorce. Because this would eliminate any step-up in basis of depreciable property so transferred, Section 1239 would also be amended to eliminate spouses from the term "related persons".

We believe the proposed rule providing for nonrecognition of gain or loss on any transfer of property between spouses or incident to a divorce is a fair and reasonable solution to a troublesome problem. However, we think proposed new Section 1041(c), which would define a transfer "incident to divorce" as either a transfer that occurs within one year after the date on which the marriage ceases or a transfer that is related to the cessation of the marriage, is too encompassing. An extension of nontaxability (and carryover of basis) to every transfer between former spouses within one year after the divorce is for purposes of administrative convenience, and is designed to eliminate abuses associated with property transfers improperly disguished as not being incident to a divorce. However, the proposed definition is not only arbitrary and inflexible, but also at odds with the basic concept of the proposed general rule, i.e., nontaxability for only those transfers that are incident to a divorce. The proposal would eliminate current taxability and basis step-up for any bona fide transfer for nontax reasons that truly has no connection with a divorce.

We think the concept of a property transfer "incident to divorce" and its definition can be harmonized within the bounds of administrative needs. This could be accomplished by establishing a *rebuttable* presumption that a transfer of property within one year after a divorce is "incident to divorce". This rebuttable presumption could be established in proposed new Section 1041(c) with language such as:

(c) Incident to Divorce.—For purposes of subsection (a)(2), a transfer of property is presumed to be incident to divorce if such transfer—

(1) occurs within one year after the date on which marriage ceases, or

(2) is related to the cessation of marriage.

The presumption established in subparagraph (1) of this subsection can be rebutted by the taxpayer on a proper showing that, under the facts and circumstances relating to the property, transfer, such transfer clearly has no connection with the divorce or the cessation of marriage.

Alimony

Section 203 of the Bill would amend Section 71 relating to alimony and separate maintenance payments. More specifically, proposed Section 71(a) would provide, as a general rule, that gross income includes amounts received as alimony or separate maintenance payments. Under proposed Section 71(b)(1), to qualify as an alimony or separate maintenance payment, a cash payment must be received by a spouse under a "divorce or separation instrument". (Other conditions not relevant here also apply.) Proposed Section 71(b)(2) defines a "divorce or separation instrument" as: (A) a decree of divorce or separate maintenance, or a written instrument incident to such a decree, (B) a written separation agreement or (C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

Under present law, modifications of written separation agreements entered into before a divorce have been recognized as valid by both the Internal Revenue Service and the courts in a number of instances. See, for example, Rev. Rul. 60-140, 1960-1 C.B. 31 (1960); Rev. Rul. 60-141, 1960-1 C.B. 34; *Newton* v. *Pedrich,* 212 F.2d 357 (1954); and *Hollander* v. *Comm.,* 248 F.2d 523 (1957). These authorities held that subsequent modifications were "incident to the divorce", and therefore valid for tax purposes. In other cases and rulings, however, subsequent modifications or agreements were held to be "voluntary" and the payments were neither deductible by the payor nor includable by the recipient. See Rev. Rul. 60-142, 1960-1 C.B. 34 (1960); *Cox* v. *Comm.,* 176 F.2d 226 (1949); and *Comm.* v. *Murray,* 174 F.2d 816 (1949). The distinction between those authorities that have upheld a modified agreement and those that have not seems to hinge on a mere technicality—whether the obligation to support survives the dissolution of the marriage or whether the parties have made a voluntary amendment without a legal quid pro quo.

We propose that an increase in alimony payments pursuant to a modified agreement should be deductible regardless of whether the amendment is voluntary. Therefore, we believe that where a modification occurs, if the amendment is in writing and signed by both parties, and a copy is attached to each spouse's tax return, the amendment should be valid for federal income tax purposes. As presently worded, proposed Section 71(b)(2) would not clarify that such a modified separation agreement would be valid, in all cases, without having to resort to the formalities, personal anguish and legal procedures involved in modifying the divorce decree. Consequently, we submit that the bill should be amended to include a new Sec. 71(b)(2)(D), with the following (or similar) wording:

> (D) a written amendment to any instrument described in subparagraphs (A), (B) or (C) if such amendment is signed by both parties and is attached to the income tax returns of both parties for the taxable year for which the modification first becomes effective.

TITLE III—REVISION OF AT-RISK RULES FOR THE INVESTMENT TAX CREDIT

The Bill would amend the at-risk rules applicable to the investment tax credit (ITC) by replacing the existing positive at-risk requirements of Section 46(c)(8)(A) through (E) with new rules that provide for the exclusion of certain types of financing from the "credit base". The proposed amendments to Section 46(c)(8) are intended to permit allowance of the full ITC to taxpayers in most bona fide business acquisitions of qualifying property, while protecting against possible abuses through use of certain nonrecourse financing.

We support Title III of the Bill, but recommend certain changes, as noted below, to clarify its application and revise certain provisions that appear unduly restrictive.

Definition of nonrecourse financing

Proposed Section 46(c)(8)(D)(iii)(I) would include in the definition of nonrecourse financing, "any amount with respect to which the taxpayer is protected against loss through guarantees, stop-loss agreements, or other similar arrangements". This language is essentially the same as that in existing Section 465(b)(4) and Proposed Regulations 1.465-6 and 1.465-20.

However, under a broad, literal interpretation of this rule, nonrecourse financing treatment may apply in some situations in which there is no borrowing, direct or indirect, by a limited partnership or S corporation with respect to the acquisition of qualifying property. We recommend the wording to the Bill be changed to make it clear that this rule does not apply to the acquisition of qualifying property where: (a) No borrowing exists with respect to the property, and (b) The taxpayer is not protected against loss by any third party agreement, indemnity, etc.

Borrowing from a related person

Proposed Section 46(c)(8)(D)(iii)(II) would treat *all* borrowing from a "related person" as nonrecourse financing, *and* would reduce the 50 percent threshold of existing Sections 267(b) and 707(b)(1) to 10 percent. The application of this rule may be very harsh, as demonstrated by the following example of an ordinary commercial transaction:

Individual A owns 1 percent of the stock of X, an S corporation, and 11 percent of the stock of Y, a commercial bank. A is not related to any of the other shareholders of X or Y within the meaning of Section 168(e)(4).

X, which owns no stock in Y, borrows $100,000 from Y, with full recourse to X, and purchases qualifying property for $100,000. The transaction meets all of the requirements of proposed Section 46(c)(8)(E)(ii).

The recourse debt to Y would be considered nonrecourse financing under proposed Section 46(c)(8)(D)(iii)(II), but only as to A. Further, it would be nonqualified nonrecourse financing because it would not meet the definition of "qualified commercial financing" under proposed Section 46(c)(8)(D)(ii).

Result: All of the shareholders of X *except A* would be entitled to their respective shares of the investment tax credit. A would become entitled to claim his share of the credit only as X reduces its debt to Y.

We therefore urge that the definition of "related person" for purposes of Section 46(c)(8)(D)(iii)(II) be determined under Sections 267(b) and 707(b)(1) *without* modification of the 50 percent-ownship rule.

Definition of related person

Proposed Section 46(c)(8)(D)(v) would define a related person "For purposes of clause (i) . . .". This appear incorrect. Presumably, the definition is meant to apply for all purposes of this paragraph . . .".

Treatment of a limited partner

Proposed Section 46(c)(8)(E) is intended to clarify the rules for partnerships and S corporations. A limited partner, however, would be placed at a disadvantage in relation to a shareholder in an S corporation in the case of certain recourse financing.

Recourse financing to a limited partnership imposes personal liability on the general partner(s) but not on the limited partner(s). Under the Bill, all recourse financing to a limited partnership would be considered nonrecourse financing as to a limited partner, and must meet the definition of "qualified commercial financing" in order for the limited partner to qualify for full investment tax credit.

We recommend that proposed Section 46(c)(8)(E)(ii) be retitled: "Special Rule For Certain Recourse Financing of Limited Partnership or S Corporation", and the specific provisios of clause (ii) be changed accordingly to cover a limited partner in a limited partnership as well as a shareholder of an S corporation.

Definition of active conduct of a trade or business

Proposed Section 46(c)(8)(E)(iii)(II) would require an S corporation to have at least "3 full-time emplolyees substantially all the services of whom were services directly related to such trade or business" in order to meet the test of proposed Section 46(c)(8)(E)(ii)(II). The apparent purpose of the "three-employee" rule is to provide an objective standard for determining whether an S corporation is engaged in the active conduct of a trade or business, but we believe this is overly restrictive.

Many small businesses that are unquestionably engaged in the active conduct of a trade or business have only one or two employee actively conducting day-to-day operations. These legitimate businesses may be operated in sole proprietorship, partnership or corporate form, but this rule would deny ITC only to those choosing to operate as limited partnerships or S corporations (where the only full-time "employee" may be the general partner or the sole shareholder).

The "active conduct of a trade or business" determination is a question of fact and not an objective standard. This is consistently recognized in the Code and regulations and by the courts. For example the trade or business requirement appears in the following sections of the Code without further definition or qualifying language:

Section 44F(b)(1)—Qualified Research Expenses.

Section 162(a)—Trade or Business Expenses.

Section 165(c)(1)—Limitations on Losses of Individuals.

Section 166(d)(2)(A)—Definition of Nonbusiness Debts.

Section 172(d)(4)—Nonbusiness Deductions of Taxpayers. Other Than Corporations.

Section 179(d)(1)—Definition of Section 179 Property.

Section 195(b)(1)—Definition of Start-Up Expenditures.

These examples were taken only from Subchapters A and B of the Code to illustrate the frequency of use.

We believe the term "active conduct of a trade or business" is self-definitive, and we therefore urge deletion of proposed Section 46(c)(8)(E)(iii)(II) from Title III of the Bill.

Recourse seller financing

Under the Bill, recourse financing from either the seller of the property or a person related to the seller ("recourse seller financing") would be treated as nonrecourse financing as to a limited partner or a shareholder in an S corporation. Individual proprietors, general partners and C corporations could include recourse seller financing in their "credit base" without limitation.

Recourse seller financing is a common practice, and many manufacturers have wholly-owned subsidiaries devoted almost entirely to financing purchases of the parent corporation's products. The exclusion of bona fide, arms-length recourse seller financing from the credit base of a limited partner or a shareholder in an S corporation would create an unduly harsh restriction.

We recommend that proposed Section 46(c)(8)(E)(ii) be changed to include in the definition of "qualified person" (solely for this purpose) an exception to proposed Section 46(c)(8)(D)(iv)(II) where: (a) The seller regularly sells the same type of property at the same price and under the same terms, or (b) The price and terms approximate an established level in the marketplace as evidenced by a published price list or other evidence of an arms-length transaction.

TITLE VIII—SIMPLIFICATION OF TAX CREDITS

Required limitation on current use of research credit

Section 804 of the Bill would amend Section 38 to combine several credits, including the research credit, into a "General Business Credit." Proposed Section 38 would also impose an overall limitation on the use of the General Business Credit in any taxable year, equal to the sum of $25,000 plus 85 percent of the excess of the taxpayer's net tax liability for the taxable year over $25,000.

Since this limitation would apply to the entire General Business Credit, it would limit use of the research credit. The computation of the allowable research credit is already limited by Section 44F to an incremental amount (the excess of the current year's qualified expenditures over the average expenditures in the base period). Therefore, we believe it is inappropriate, merely in the name of simplification, to impose an additional limitation on use of this important incentive provision. Many companies that can benefit from the research credit view it as an additional incentive to continue and expand research activities only where it provides the maximum current tax benefit to assist in generating funds for such purposes.

We therefore recommend that an exception be provided to the overall limitation on use of the General Business Credit to allow available research credits to fully offset current tax liability. We acknowledge that any exception to a general rule can undermine the objective of simplification. Nonetheless, we think the objective of simplification must be weighed against the objective of encouraging expanded research activity. We believe an exception to the general limitation would preserve the incentive without adding undue or unwarranted complexity.

Typographical error

Section 804 of the Bill would amend Section 39 to specify rules for carrybacks and carryovers of unused credits. There is an apparent typographical error in proposed Section 39(d)(1)(A), which contains the phrase ". . . a business credit carryforward to each taxable year beginning after December 3, 1983. . . ." It appears this date should be December 31, 1983.

Attachment.

EXHIBIT I.—SIMPLIFIED APPROACH FOR DETERMINING THE AMOUNT OF REQUIRED INSTALLMENTS UNDER PROPOSED SECTION 6654(d)

[In percent]

	Installment due date			
	Apr. 15	July 15	Sept. 15	Jan. 15
A. Current year's tax	20	40	60	80
B. Prior year's tax	25	50	75	100
C. Tax on annualized income for months ending before the installment due date	20	40	60	80
D. Lowest of A, B, or C				
E. Less: Cumulative prior Required Installments (total of F for prior installment due dates)	([1])			

EXHIBIT I.—SIMPLIFIED APPROACH FOR DETERMINING THE AMOUNT OF REQUIRED INSTALLMENTS UNDER PROPOSED SECTION 6654(d)—Continued

[In percent]

	Installment due date			
	Apr. 15	July 15	Sept. 15	Jan. 15
F. Required installment (D minus E)				

[1] Not available.

University of California,
Los Angeles, Calif., August 3, 1983.

John J. Salmon,
Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C.

Dear Mr. Salmon: This letter is written testimony concerning H.R. 3475. I hope it reaches you before the record closes. I shall comment only on the provision in Title II relating to Domesitc Relations. I have written a number of articles about the tax problems of marital dissolution and also taught CLE courses on it.

a. Property Settlements. I enthusiastically support §202 which would make transfers of property pursuant to property settlements nontaxable events. It deals correctly and concisely with the problem both in community property and non-community property states.

I would suggest that any transfer called for in a property settlement agreement or a divorce decree should come within new §1041, even if the actual transfer occurs more than one year following divorce. As drafted, you allow people an election to make their transfers taxable (i.e. pursuant to existing law) simply by waiting one year after the divorce becomes final to make the transfer. People might wish to do this either to recognize a loss or to obtain a stepped-up basis. I see no justification for taxable property settlements at any time.

Ideally, §1041 should apply to transfers between separating cohabitants as well as spouses. At present, such a transfer is probably a realizing event to the transferor and also fully taxable as ordinary income to the transfree. It would be desirable to deal with the tax problems of terminating cohabitants at the same time. This is a relatively new problem but one which will grow in importance in the future as more states recognize that property and support rights can arise from long-term cohabitation. I will make a suggestion below as to how the problem might be handled.

b. Alimony. Although I strongly support simplification of present law, by removing the support and periodicity requirements, I believe that revised §71 is unnecessarily complex. It looks like a compromise provision and it suffers from the defects of compromises—undue complexity and the lack of a clear underlying rationale. This is unfortunate. Marital dissolution legal work is done by a group of attorneys almost universally unschooled in tax fundamentals. They are completely mystified by present law. If there are ways to foul thing up, they will find them.

Your goal must be to create a fool-proof provision to prevent errors and avoid tax disputes and litigation. In § 1041, you have drawn a provision so simple that the tax consequences of a property settlement will be the same whether the attroneys know what they are doing or not. But you have done the opposite in revised § 71. There are too many ways that an alimony deduction can be lost or in which a tax dispute can be created or inconsistent treatment encouraged by practitioners who do not understand the ground rules.

The provision that a deductible payment cannot be made in exchange for a transfer of property by the payee spouse will cause much confusion. I take it, from the Joint Committee summary, that you are trying to get rid of the confusing body of existing law which seeks to distinguish payments which discharge property claims from payments which discharge support claims. In particular, you seek to repudiate the recent decision in Beard v. Commissioner, 77 T.C. 1275 (1981), which holds that a payment in discharge of a claim for equitable distribution is not a payment for support. Instead, you wish to provide that no deduction be allowed for the sort of payments described in Carrieres V. Commissioner, 64 T.C. 959 (1975), aff'd, 552 F.2d 1350 (9th Cir. 1977)—promissory note in exchnage for spouse's interest incommunity property stock.

Unfortunately, I do not believe that the language chosen will achieve the desired result. There is no clear distinction between community property and property rights under modern equitable distribution statutes. Most community states (including Texas) do not mandate equal divisions of community property; unequal divisions are the norm. In contrast, the rights of a non-title-holding spouse in an equitable distribution state are relatively well defined. The non-owning spouse is entitled at divorce to an equitable share of the marital property, which he or she earns by the rendition of household or other sevices. Often, the title-holding spouse makes a cash payment to the other spouse to acquire his or her rights in such property.

It will not be clear whether cash payments made in community property states or in equitable distribution states will be in exchange for spousal support, or for a "net transfer of assets," or for "relinquishment of . . . marital rights under local law." The Joint Committee Summary seems to assume that these are water-tight categories, but in real life they are not exclusive or easily distinguished at all.

I suggest you abandon the enterprise. I understand that you are trying to curb opportunities for income splitting between high and low bracket spouses. Your provision requiring that more than 50% of the payments be made after the first year is sound. It is adequate protection against making lump sum payments deductible, But trying to distinguish property and support payments (or between different kinds of property payments) is just impossible and your provision will insure that spouses will treat payments inconsistently, generating countless unnecessary audits and unnecessary Tax Court cases. In my opinion, it would be better to simply accept the fact that some income splitting is going to occur. Allow the spouses to decide whether payments should be deductible or not. You have already gone so far in accepting income splitting in the divorce context that allowing deductions for additional payments for property is not very significant.

I also have doubts about the provision that requires a cutoff at the death of the payee spouse. Again, I take it that you are trying to prevent the deduction of payments which are really property settlements. You are willing to allow deductible payments to continue after a payee spouse remarries (an issue frequently disputed under present law which makes the result vary depending on state law), or after a payor spouse dies, but not after a payee spouse dies. In this respect, you are taking away some flexibility available under present law (under § 71(c)(2) payments over more than a ten-year period are deductible even if they aren't contingent at all).

If H.R. 3475 is enacted, planners who want installment payments to become deductible will have to build in a contingency based on the death of the payee spouse. This will result in the unexpected loss of benefits by the families of such recipients who die early. Alternatively, other inept planners will forget to build in the death-cutoff or it will be unclear. For example, it will be unclear whether there is a substitute payment at the payee's death or there will be disputes about whether state law causes such payments to terminate at death if the parties make no provision either way. And I am puzzles why a deduction should be disallowed for payments which would terminate upon the remarriage of the payee spouse but which would not terminate upon her death prior to remarriage. Again, I would abandon your proposed § 71(b)(1)(E) and just accept that a few spouses are going to cast into deductible form installment payments of non-contingent obigations.

I think a $50 penalty may be too low to encourage a payee spouse to supply a social security number. Also it will be difficult to deal with the argument by the payor that the payee refused to furnish him with a number; how are we to know whether she did or not? I would think that a superior provision would simply deny the deduction unless a correct ID number is supplied, unless the payor adequately explains the failure to supply it. Such an explanation would have to include the name, address and telephone number of the payee spouse. Alternatively, or in addition, you could provide for a penalty of 25 percent of the amount claimed as income or deduction, with a $50 minimum.

I would also like to see a provision which rendered post-separation cash payments as well as transfers of property non-taxable to a former cohabitant. At present, it appears that such payments or property transfers are non-deductible to the payor but includible as ordinary income to the payee, unless they can be characterized as gifts which would be highly problematic in the circumstances. No deduction should be available in these situations, and gain on property transfers should be available in these situations, and gain on property transfers should be realized, but double taxation (in the form of ordinary income to the recipient) is too severe. A provision which excludes payments pursuant to written agreement or court decree to a former cohabitant would be equitable and would probably entail no loss of revenue (since such payments are probably excluded by most recipients at present and are seldom detected upon audit).

c. Dependency. I agree with the abolition of the $1200 test under § 152(e)(2) (B) of existing law. Although it was an improvement over prior law, it still is a prime producer of disputes and litigation. However, I believe your proposal is too restrictive. Why should it be necessary that the custodial and non-custodial spouses negotiate every year about the exemption? I assume you contemplate annual negotiations in which they bargain over the exemption; the spouse who takes it pays the other for the privilege (and also, perhaps, cleans up his delinquent child support payments).

As I lectured recently about the proposed legislation to family law specialists, the audience laughed uproariously at the idea that there would be an annual negotiation. Divorced spouses just aren't reasonable in many situations. former spouses who loathe one another shouldn't be forced into annual trauma sessions or, alternatively, to pay attorneys' fees annually which will probably exceed the tax savings from the exemption. To forestall such distasteful, unpredictable and expensive encounters, counsel will have to advise non-custodial parents, at the time the original deal is made, to secure signed waivers convering every future year in which each child might be claimed as an exemption. But given this may be difficult if the IRS periodically alters the form on which such waivers must be made.

I suggest you retain the provision in present law giving an exemption to a spouse (who, unlike present law, could be either the custodial or non-custodial parent) to whom it is allocated by agreement and who supplies support of at least $600 per year. You might require that such an agreement contain a promise by the other parent never to claim the exemption. You could also require once again the provision of the other parent's social security number. Perhaps the $600 figure should be increased to a more realistic sum. But the advantage of the $600 provision of § 152(e)(2) (A) of existing law is that it does allow the spouses to tie down the issue once and for all by negotiating it at the same time as all other issues are settled. They don't have to hassle over it each year or suffer the risk of tax disputes from an inconsistent treatment each year.

However, your provision for annual waivers should be retained as an alternative for people who made no previous allocation. And if there is no prior agreement or annual waiver, I quite agree that there should be an absolute rule allocating the exemption to the custodial parent.

d. Estate tax. Your proposed § 2043(b)(2) appropriately permits transfers under property settlements to supply adequate consideration for the reduction of debts. In addition, you should expand this provision so as to make such transfers adequate consideration to defeat inclusion of property in the transferor's estate under §§ 2036–38 and 2041.

Thank you for the opportunity of commenting on this legislation. Although it could be improved, in ways I have outlined in this letter, it will be a vast improvement in the law even if enacted in its present form.

Sincerely,

MICHAEL ASIMOW,
Professor of Law.

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C., July 15, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, 1102 Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Earlier this year, the Banking and Ways and Means Committees were referred letters from the Treasury Department requesting an amendment to their authority to use a working capital fund and new authority to establish a gift fund. Those proposals have now been incorporated in H.R. 3475, which has been referred to your Committee.

We have analyzed the Treasury proposals, as outlined in their letters, and the Banking Committee has no objection to the Ways and Means Committee proceeding to deal with those proposals in connection with H.R. 3475. There is one matter, however, that we consider important if the gift fund authority requested by Treasury is to be enacted. In discussions with the staff of the General Accounting Office, we have been advised that some concerns have been raised in GAO reports relating to the purposes for which gift funds are used. In some cases, according to GAO, these funds have been used to augment amounts made available by appropriations for travel and entertainment expenses.

GAO's main concern at this point seems to be that agencies be required to disclose the sources of the income into the gift fund and the purposes of any expenditures from the fund. I would suggest that your Committee either amend the proposed statutory language or insert language in the Committee report specifying that this type of disclosure should occur in the Department's annual budget submission. Should you wish, we would be pleased to work with you on preparing such language.

The Banking Committee appreciates your attention to this matter.

Sincerely,

FERNAND J. ST GERMAIN,
Chairman.

STATEMENT OF WILLIAM W. BROWN, CERTIFIED PUBLIC ACCOUNTANT, REDDING, CALIF.

This statement directs itself only to the provisions of the Bill dealing with the representation by C.P.A.'s or Enrolled Agents before the U.S. Tax Court under the Small Case Procedure.

For years taxpayers who could not settle their disputes with the Internal Revenue Service had to either represent themselves or hire an attorney to represent them in Tax Court either as a regular case or as a small tax case. While all attorneys were permitted to practice before the court non-attorneys had to pass an examination in order to practice before the court. In fact, many C.P.A.'s and Enrolled Agents did practice by helping taxpayers prepare for court trials and writing briefs. This was confirmed in a discussion of the problem with a Tax Court Judge. This bill seeks to correct this situation by allowing C.P.A.'s and Enrolled Agents who are authorized to practice before the Internal Revenue Service to represent taxpayers in small tax cases.

The bill goes further to eliminate any new non-attorneys from even practicing before the Tax Court in regular cases by doing away with the special examination. These provisions will then enable taxpayers with small cases to engage either an attorney, C.P.A. or Enrolled Agent to represent them while allowing only attorneys to represent taxpayers with large cases. If a taxpayer has a larger case he should have an attorney to represent him. These provisions are a needed improvement in the handling of tax disputes.

However, I believe that the bill should go further and raise the limits of small tax cases to $10,000 per year. Many of the uncomplicated cases can get up to $5,000 in a hurry. Therefore, I am seeing a need to increase this limit. If the Committee sees a need to have step increase over the 3 to 5 years that would be an acceptable alternative.

STATEMENT OF THE CHAMBER OF COMMERCE OF THE UNITED STATES BY RACHELLE B. BERNSTEIN [1]

The Chamber of Commerce of the United States, representing over 213,000 businesses, trade associations, and local and state chambers of commerce welcomes the opportunity to submit testimony on H.R. 3475. The Tax Law Simplification and Improvement Act of 1983.

SUMMARY

The Chamber commends Chairman Rostenkowski and Mr. Conable for their efforts to simplify and improve our tax laws. We believe that H.R. 3475 is an important first step in simplification of the Code. However, we do not believe that simplification should result in the cutting back of certain deductions or credits which are presently allowed. We offer the following suggested revisions to the at-risk, foreign, and income tax credit provisions of the bill.

REVISION OF AT-RISK RULES FOR THE INVESTMENT TAX CREDIT

Section 465 limits the amount of losses that can be taken with respect to an activity to the amount the taxpayer is "at risk" in the activity. Generally, a taxpayer is treated as being at risk only to the extent of any cash or property invested in the activity and any borrowed amounts for which the taxpayer is personally liable.

---

[1] Senior Tax Attorney, Tax Policy Center, Chamber of Commerce of the United States.

Under Section 465(b), amounts borrowed on a nonrecourse basis or from related parties are not treated as being at risk for purposes of computing the loss limitation. Section 46(c)(8) imposes a similar at-risk limitation on the amount of investment tax credit, but contains an exception for nonrecourse financing through qualified lenders, such as banks, savings and loans and governmental entities. Provided at least 20 percent of the basis of the investment tax credit property is fully at risk, nonrecourse financing through qualified lenders is treated as being at risk for purposes of section 46(c)(8).

These at-risk provisions apply to any corporation more than 50 percent of the stock of which is owned (actually or constructively) by 5 or fewer shareholders.

The at-risk rules were originally intended to discourage investment in abusive tax shelters, which rely heavily on nonrecourse and related-party financing to generate artificial losses and credits. In 1978, Congress extended section 465 to cover all closely held corporations and broadened the application of the at-risk rules. The rules were later imposed on the investment tax credit.

Broadening the at-risk rules has created serious and unintended problems for many closely-held corporations, many of which are small family-owned businesses. Present sections 465 and 46(c)(8) operate without regard to the type and scope of activity in which a corporation is engaged. As a result, thousands of closely held corporations engaged in bona fide business activities have found themselves subject to an onerous set of rules for no reason other than the number of their shareholders.

Closely held corporations are put at a competitive disadvantage by being denied the right to use losses generated by one line of business to offset income from another. The at-risk rules restrict the availability of seller financing to expand product or service lines or make investments in capital equipment, despite the fact that these techniques are widely-recognized in financial circles as sound and effective means of business expansion.

Under Temporary Treasury Regulations section 5.1502–45, closely held corporations that conduct business activities through subsidiaries are subjected to a harsh rule which denies the utilization of a subsidiary's losses to offset income of its consolidated group to the extent the losses exceed the lesser of the subsidiary's amount at risk in the activity or the parent's amount at risk in the subsidiary. The result in many cases is to disallow losses that would have been allowable in full if the activity had been conducted by the parent.

Section 301 of the bill acknowledges the inequities created by strict application of the at-risk limitations to corporations engaged in bone fide business activities. The bill would treat S corporation shareholders as at-risk with respect to certain recourse financing obtained by the corporation, provided specified active business tests are met, and would clarify section 46(c)(8). However, the bill does not address the problems faced by closely-held corporations generally.

Much more extensive revision of the at-risk rules is needed, both in the investment tax credit area and with respect to the loss limitations contained in section 465. As shown above, the existing at-risk rules discourage closely-held corporations from engaging in productive activities, and the unfairness is particularly severe when a closely held business must operate through subsidiaries. At the July 25, 1983 hearing before the House Ways and Means Committee on H.R. 3475, Ronald A. Perlman, Deputy Assistant Secretary (Tax Policy) of the Department of the Treasury stated, "To the extent that the present at-risk rules frustrate legitimate business transactions or impose unnecessary limitations on taxpayers, relief should be provided."

A solution to the problem might be based on H.R. 883, introduced by Representative Pickle on January 25, 1983. H.R. 883 would exempt certain activities from the operation of the at-risk limitations, provided: (1) the activity constitutes a trade or business, (2) the corporation is actively engaged in the management of the trade or business; and (3) at least three nonshareholder employees of the corporation are engaged full time in the trade or business. In the case of a partnership, the number of full-time employees must equal or exceed three times the number of partners that are closely held corporations, determined without regard to which partner provided the employees. The bill would treat members of a consolidated group as a single corporation for purposes of determining whether an exemption is available.

We support the thrust of H.R. 883. It would ensure that only *bona fide* business activities qualify for the exemption, while passive tax shelter activities remain subject to the current rules. However, we believe that the active-business and active-management tests are sufficient, and a test based on number of employees is redundent. Also, participation in either the management or the direction of an activity should suffice.

FOREIGN TAX PROVISIONS

1. Definition of resident alien

The determination of whether a person is considered to be a resident or nonresident alien has presented problems in the past because the Internal Revenue Code does not define these terms, and the Treasury regulations which govern this area do not contain a clear definition of these terms. Section 501 of H.R. 3475 sets forth a more precise definition of resident aliens for U.S. tax purposes adds much needed clarity to this area of the Code.

Under section 501, an individual would be considered a U.S. resident if he is a lawful permanent resident at any time during the calendar year, has an application for a visa and is present in the U.S. for at least 60 days, or meets the substantial presence test. Under the substantial presence tests, individuals who are in the United States for at least 183 days during a 3-year period (weighted toward the present year) will be considered resident aliens. However, two exceptions are provided to this rule: (1) an individual present in the United States for less than one-half of the current year and having a closer connection to a foreign country than to the United States; or (2) a foreign government-related individual, a teacher or trainee, or a student, (where facts and circumstances indicate that such person does not intend to premanently reside in the United States).

We believe this definition, in general, correctly distinguishes between resident and nonresident aliens. However, we are concerned about the situation where a foreign employee of a U.S. based company may be required to spend several months a year in the United States for a period of several years. This is a common situation where executives of foreign branches or subsidiaries are required to come to the United States to participate in developing marketing or industrial strategies. The normal circumstances of this type of situation would clearly place such an individual within a nonresident characterization under the statute; however, there may be an occasional situation whereby such an individual is in the United States for more than 183 days (as weighted by the statute) during a three-year period. We believe that such an individual should be considered to be an "exempt individual" under Section 501(b)(3). There does not seem to be any difference between a foreign employee who spends time in the United States performing such normal business-type activities and a teacher or trainee who would be exempt under this section. Furthermore, we believe that clarification is needed of the provision which excepts a person from the "exempt individual" status if facts and circumstances indicate that the individual intends to permanently reside in the United States.

2. Ordinary income treatment on disposition of stock of certain foreign corporations

The provision of H.R. 3475 relating to Internal Revenue Code Section 1248 adds much needed clarification to this section of the Code and will aid taxpayers in being able to anticipate their tax liability with more certainty.

3. Stapled stock

Although we do not disagree with the intent of this provision, the language is overly broad, raising many questions as to its application. For example, if a foreign corporation is deemed to be domestic under this provision, how will the foreign tax credit be calculated with respect to that corporation? Will Section 338 of the Code apply to this deemed "domestic" corporation? What would the result be if the owners wished to convert this deemed "domestic" corporation to a domestic corporation?

Section 506(b) of H.R. 3475 gives the Secretary of the Treasury the authority to prescribe whatever regulations may be necessary to prevent avoidance or evasion of Federal income tax through the use of a stapled entities. Because the legislative language of this provision is so broad, Treasury will be given too much authority in deciding the pervasiveness of the legislation. The intent of this provision should be more clearly stated in the legislation to insure that the Treasury Department carries out the intent of Congress in issuing regulations.

SIMPLIFICATION OF INCOME TAX CREDITS

Title VIII of H.R. 3475 attempts to apply a logical order to the allowance of the various tax credits against tax liability and to provide uniform rules for their application. This is a proper goal and provides much needed simplification to the tax code. However, this goal is accomplished by lumping all the "business" credits (which include the investment tax credit for both regular and energy credits, the targeted jobs credit, the alcohol fuels credit, the research credit, and the ESOP credit) into one combined general business credit for which one rule as to application is provided. Thus, this general business credit would be allowable against 100 percent of the first $25,000 of tax liability and 85 percent of the remaining tax liability and would be used on a first-in, first-out basis with a 3-year carryback and a 15-year carryforward. These rules are the same as those presently provided for the investment tax credit; however, all the other business tax credits may be applied against a greater amount of tax liability in a given year. Thus, although these rules provide uniformity, they deprive taxpayers of part of the value which they are receiving from these tax credits under the present law. The bill would also require that unexpired carryovers be subject to these new rules, causing hardship to taxpayers who entered into investment transactions based on present law.

We believe that Congress intended that taxpayers receive the value provided under present law as an incentive for performing certain types of economic activity, and that this value should not be reduced merely for the sake of simplification. Therefore, if uniform rules are to be provided for the use of these credits they should allow the general business credit to be allowed against 100 percent of tax liability (as is presently allowed for the research and energy credits). This would provide a uniform rule without cutting back on the amount of credit presently allowed.

Furthermore, we suggest that the carryforward and carry back rules and the credit ordering rules which are to be applied to this general business tax credit should also be applied to the foreign tax credit. Under present law, the foreign tax credit may be carried back two years and forward five. The ordering rules for foreign tax credits require that these credits be used on a last-in, first-out basis, so that the current year's credits must be utilized before any carryovers. The effect of these rules is to penalize taxpayers in distressed industries, by denying them use of their foreign tax credits. The purpose of the foreign tax credit is to avoid double taxation of U.S. taxpayers, but this intent is often not accomplished bacause of the short carryover period and the ordering rules.

As is true of the other business tax credits addressed by Title VIII of this bill, there seems to be no rationality between the difference in treatment of the foreign tax credit and the other tax credits. Therefore, we suggest that for the sake of both simplification and equity the carryover and ordering rules of the foreign tax credit be conformed to the other business tax credits so that the foreign tax credit has a 3-year carryback and a 15-year carryforward period and is applied on a first-in, first-out basis.

CONCLUSION

We commend the Committee for its efforts to simplify the tax code. The increasing amount of tax legislation enacted over the past several years has caused our tax laws to become increasingly complicated and the reconciliation of these laws with a consistent tax policy has, in many instances, been lost. We agree with the statement made by Representative Conable at the commencement of the Committee's hearings on H.R. 3475, that tax simplification should not result in an increased tax burden. Thus, we oppose any attempt which this bill makes to cut back on tax credits presently being received.

EDISON ELECTRIC INSTITUTE,
Washington, D.C., July 29, 1983.

Mr. JOHN SALMON,
Chief Counsel, House Ways and Means Committee, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: These comments are being submitted on behalf of the Edison Electric Institute (EEI) with respect to the Tax Law Simplification and Improvement Act of 1983 (H.R. 3475). The provisions of H.R. 3475 of particular interest and concern to EEI are included in Title VIII; therefore, comments are limited to Title VIII.

EEI is the national association of investor-owned electric utilities in the United States. The member companies of EEI serve 99.6 percent of the ultimate customers of the investor-owned segment of the industry, about 70 million electric consumers, comprising 77.5 percent of all electricity users in the country.

EEI recognizes that one of the purposes of Title VIII of H.R. 3475 is to simplify the determination of the allowance of the various non-refundable tax credits against a taxpayer's income tax. Another purpose is to provide for a better opportunity for utilization of tax credits that, under current law, may have limited carryover periods. EEI believes that these are laudable objectives. It is certainly appropriate to standardize carryback and carryover periods of three and 15 years, respectively, for the credits, and it is generally apropriate to standardize the manner in which the credits are used. However, certain provisions of Title VIII would have the effect of restincting rather than enhancing the utilization of the credits. The restriction could have a significant negative impact on electric utility companies and would be counterproductive to the need of EEI member companies to raise capital. More specific comments are presented below.

(1) Proposed section 38(b) of the Internal Revenue Code of 1954, as amended (the Code), would combine under the term "business credit" the credits generated each year for: (i) the investment credit, including the energy credit, (ii) the targeted jobs credit, (iii) the alcohol fuels credit, (iv) the research activities credit, and (v) the employee stock ownership credit, or payroll-based employee stock ownership credit. Proposed section 38(c) of the Code would limit the utilization of the business credit effectively to 85 percent of a taxpayer's current year's federal income tax liability.

Under present law, each of the credits enumerated above requires a separate calculation to determine the maximum amount to be utilized for a year. The calculations are not simultaneous and subject to a single limitation but are made progressively. That is, the limitation for one type of credit is calculated first and that credit is utilized to offset federal income tax liability. Then, the limitation for another credit is calculated on the basis of the federal income tax liability that remains after applying the other credit. The combining of the credits into a single general business credit subject to a single limitation based upon a taxpayer's tax liability would have the effect of reducing the amount of tax liability against which these credits may be applied, thereby increasing a taxpayer's tax liability.

Many electric utility companies are in the position of having significant amounts of unused credits to be carried over to future years. The proposed change by means of Code sections 38 (b) and (c) to one overall credit limitation would retard the utilization of credit carryovers. That result would not reflect the longstanding intended purposes of the credits and would not be justified on the ground of Code simplification. Simplification is highly desirable but Code substance is far more important. One solution to alleviate the expected economic hardship that would result would be to modify the limitation so that the credits could be used to reduce 90 percent of a taxpayer's tax liability. Another solution would be to exclude the payroll-based employee stock ownership credit from one of those comprising the business credit. The wage-based employee stock ownership plan credit is easily distinguished from the other credits in that it represents a form of compensation to employees. On the other hand, the investment credit, the targeted jobs credit, the alcohol fuels credit, and the research activities credit are very much different in nature.

(2) Another problem is that H.R. 3475 does not provide the order for determining the utilization of the individual credits, which would comprise business credit, for a particular vintage year. Because regulatory agencies and the Code prescribe ratemaking treatments for certain of the credits and these treatments are not all the same, this lack of an ordering of the use of the various credits is likely to result in regulatory confusion and conflicts under the Code over the priority of usage. In any event, public utilities could be harmed. This would be a problem where only a portion of the business credit for a particular vintage year is used to reduce tax liability, and the balance of the business credit is carried over.

H.R. 3475 should be clarified to identify the order in which the various credits, of a given vintage year, which comprise the business credit, are deemed to be used in a given vintage year. It would be preferable to have the investment credit (not including the energy credit) be deemed to be used prior to the use of other credits. This would facilitate the determination of the amount of the credit required to be normalized under Code section 46 (f) and the allowance of the deduction under Code section 196 for any investment credit that expires unused.

(3) H.R. 3475 provides "conforming amendments" to codify its provisions with respect to the tax credits. One of the conforming amendments would repeal the employee plan percentage for TRASOP investment credits, presently provided by Code section 46(a)(2)(A)(iii). Apparently the rationale for repealing the TRASOP investment credit is that because, under present law, the employee plan percentage is applicable only to qualified investment for taxable years ending before January 1, 1983, the provision for the TRASOP employee plan percentage is no longer required.

However, it is important to have section 46(a)(2)(A)(iii) in effect after December 31, 1982 for companies that are in an investment credit carryover position and have elected, or intend to elect, for utilization in years after 1982, TRASOP investment credits generated prior to 1983. A similar concern exists for redeterminations of qualified investment after 1982 for tax years prior to 1983. The inference, from the conforming amendments of H.R. 3475, is that the tax credit for the employee plan percentage may not be utilized or elected after the year 1983. This inference is in conflict with Treasury Regulations, which allow companies to elect and to utilize the TRASOP investment credit in the year that the credit is utilized, even though such utilization takes place after 1983. We believe that this result does not conform with the overall intent of H.R. 3475, and it should be modified to have section 46(a)(2)(A)(iii) continue in effect.

If the TRASOP investment credit provisions are to remain in effect, then the provision in section 46(f)(9), which provides for the ratemaking treatment of the TRASOP investment credit and which would be repealed by Section 805(o)(5) of H.R. 3475, would have to be retained. Without Code section 46(f)(9), regulatory agencies could require the TRASOP credit to be flowed through for ratemaking purposes. Such an action would negate the intended benefit of the TRASOP credit.

(4) New Code section 39(b) under H.R. 3475 can be read to mean that the investment credit limitation and the limitation for all other credits for years prior to 1984 would be changed to 85 percent. H.R. 3475 should be changed to clarify that the tax credit limitations with respect to carrybacks of the business credit to taxable years prior to 1984 are the same as they were under the law in effect for those years.

Sincerely yours,

WALKER F. NOLAN,
Vice President, Legislative Affairs.

STATEMENT OF LUIS GRANADOS, MANAGING DIRECTOR OF THE EMPLOYEE STOCK OWNERSHIP ASSOCIATION

My name is Luis Granados. I am Managing Director of The Employee Stock Ownership Association, the national nonprofit association of companies with Employee Stock Ownership Plans ("ESOPs"). We have several comments to make regarding HR 3475, the "Tax Law Simplification and Improvement Act of 1983."

1. The ESOP Association supports the general purpose of the bill, to make the tax laws simpler and more uniform. The Association also supports the general idea behind Title VIII of the bill, the "Tax Credit Simplification Act of 1983." We agree that it is logical to combine the various business tax credits into one general business credit, and to bring the disparate rules regarding carryforwards, etc. into uniformity.

The manner in which HR 3475 accomplishes this harmonization will be of substantive determent to some ESOP companies. Under existing IRC Section 44G(b)(1)(a)(ii), the ESOP credit may be as high as 90 percent of the company's tax liability over $25,000. The bill would reduce this figure to 85 percent. In some cases, this will cause ESOP companies to defer or lose tax credits they would have received currently under the existing law. However, we regard the Congressional purpose of tax simplification as of great importance. Indeed, there are other provisions of the law affecting EOSPs that we believe should also be simplified. The Association is willing to work with the Committee on provisions to achieve the goal of tax simplification in the ESOP area, even if some such provisions have the effect of increasing actual tax payments of ESOP companies.

2. Proposed Section 39(d)(1)(A) governs business credit carryforwards from prior years. Some ESOP companies have unused credit carryforwards from the investment based ESOP credit, which was changed to a payroll based ESOP credit by the 1981 tax bill. This credit was defined in Section 48(n), but was actually allowed by Section 46(a)(2)(A)(iii) and 46(a)(2)(E). Since carryforwards of unused credits from Section 46 are specifically included in proposed Section 39(d)(1)(A), it is our interpretation that such carryforwards would continue to be permitted.

Another portion of HR 3475 amends Section 46 so that it no longer contains a reference to the employee plan percentage now in the above mentioned subsections of Section 46. This could conceivably create confusion as to whether the reference to Section 46 in proposed Section 39 means the current Section 46, including to the employee plan percentage, or whether it means the newly amended Section 46, which does not include the employee plan percentage. We suggest that either the statute or the accompanying Committee report should make it clear that unused investment-based ESOP credits may still be carried forward to future years.

3. Section 805(1)(2) of the bill eliminates current Section 44G(b)(1) and (2). Most of this elimination is unobjectionable, since it affects language duplicating that of the proposed general business credit. However, there is one sentence in section 44G(b)(2)(A) that may be worth preserving: "If any portion of such excess is a carryback to a taxable year ending before January 1, 1983 [the starting date for this credit], this section shall have been deemed in effect for such taxable year." This sentence eliminates confusion as to whether the payroll based ESOP credit may be

carried back to years before such credit existed. We suggest that the Committee report accoompanying the bill make it clear that the payroll based ESOP credit may be carried back to tax years before this credit existed.

4. We find the proposed opening language to new Section 42(b) to be more confusing than the straightforward language it replaces in current Section 44G(b)(3). We suggest that the opening language remain the same as it is now, with the possible exception of substituting the word "determined" for the word "allowed".

5. The proposed bill's simple repeal of Section 48(n) inadvertently leaves open the important question of the tax treatment of recaptured investment based ESOP credits. This is a gap that should be filled before the bill moves ahead.

Under existing law, when investment credits are recaptured or redetermined the employer securities transferred to the ESOP in connection with the employee plan percentatge portion of the credit must remain in the plan. In Section 48(n)(4), Congress provided employers with two alternative forms of relief in such a case. Either the employer could reduce the amount required to be transferred to the investment based credit ESOP in future taxable years, or it could take a deduction for the recaptured portion of the contribution rather than taking a tax credit.

As it stands now, the bill appears to eliminate both options by simply repealing Section 48(n) without replacing it with anything on this important point. Stock transferred to an investment based credit ESOP apparently would generate neither a deduction nor a future credit when the credit originally taken is recaptured or redetermined.

We suggest that Section 48(n)(4) be reinstated with necessary modifications to resolve this problem. The revised version might read as follows:

"Adjustments if employee plan credit recaptured.—If any portion of the employee plan credit provided by Section 46(a)(2)(A)(iii) as in effect before the passage of the Tax Law Simplification and Improvement Act is recaptured under Section 47 or such employee plan credit is reduced upon final determination—

> "(A) the employer may reduce the amount required to be transferred to a tax credit employee stock ownership plan under paragraph (1) of Section 48(n) as in effect before the passage of the Tax Law Simplification and Improvement Act, or under Section 42, for the current taxable year or any succeeding taxable year by an amount equal to such protion (or reduction), or
>
> "(B) the employer may deduct an amount equal to such protion (or reduction), subject to the limitations of Section 404."

This proposed language also corrects a technical defect in the 1981 tax act by permitting the recaptured credit to be offet against amounts required to be transferred to a payroll based tax credit ESOP as well as against an investment based tax credit ESOP.

STATEMENT ON BEHALF OF ENVENTURE CAPTIAL GROUP, INC., BUFFALO, N.Y.

MEMORANDUM—H.R. 3475—INVESTMENT TAX CREDIT "AT RISK" RULES IN LESSEE PASS-THROUGH ARRANGEMENTS

This memorandum is submitted on behalf of Enventure Capital Group, Inc. with respect to Title III of H.R. 3475. Title III of H.R. 3475 contains several revisions to the investment tax credit (ITC) "at risk" rules contained in section 46(c)(8) of the Internal Revenue Code of 1954, as amended (the "Code"). Neither H.R. 3475 nor present law, however, deal with the issue of the application of the "at risk" rules when the ITC is passed through to a lessee under Code section 48(d). The purpose of this memorandum is to recommend that any revision to the ITC "at risk" rules should clarify the treatment of the "at risk" rules to a lessee pass-through transaction and to make certain specific recommandations as to how the rules should supply. Such clarification would be consistent with the focus in the bill on technical and simplifying revisions.

Background

Under present Code section 46(c)(8), in determining the basis of property for purposes of computing the ITC, a taxpayer may include only the amount of the taxpayer's "at risk" investment in the property. In general, the taxpayers subject to the ITC "at risk" requirements are the same tax-payers who are subject to the loss "at risk" restrictions in Code section 465 and amounts "at risk" are determined in the same manner as under Code section 465. Thus, generally only investments of money or property and certain borrowed amounts for which a taxpayer is personally liable are considered "at risk." Code section 46(c)(8) provides a special exception, however, for certain "qualified" commercial nonrecourse financing incurred by a taxpayer provided the taxpayer is "at risk" in an amount at least equal to 20 percent of the basis of property. In addition, Code Section 46(c)(8) provides a special exception in the case of energy property for level payment nonrecourse financing incurred with respect to property provided that the taxpayer has an "at risk" investment at least equal to 25 percent of the cost of the property.

Title III revise the operation of Code Section 49(c)(8) by requiring that non "at risk" amounts—or more specifically, any "nonqualified" nonrecourse financing—be excluded from the credit base of property for purposes of computing the ITC. Nonqualified nonrecourse financing includes any nonrecourse financing that is not qualified commercial financing, any financing with respect to which the taxpayer is protected against loss through guarantees, stop loss agreements or similar arrangements, and to the extent provided in regulations, and financing from a person with an interest other than a creditor in an activity. In defining qualified commercial nonrecourse financing, Title III retains the 20 percent at risk requirment of present law by restricting the amount of permissible qualified commercial nonrecourse financing with respect to property to 80 percent of the credit base. Similarly, Title III retains the present exception for energy property nonrecourse financing although again the operation of this provision is changed by replacing the 25 percent at risk requirement with a restriction on the amount of nonqualified nonrecourse financing to 75 percent of the basis of the property and requiring that such nonrecourse financing be level payment financing.

In addition, Title III provides certain new rules for application of the ITC "at risk" restrictions to shareholders in S corporations.

Application of at risk rules to lessee pass-through

Under Code section 48(d), in general a lessor may elect with respect to any new section 38 property to treat the lessee as having acquired such property for an amount equal to the fair market value of the property. The effect of this election is to permit the lessee to claim the ITC, rather than the lessor, based on a deemed basis equal to the fair market value of the property.

Under existing Code section 46(c)(8), it is unclear how the ITC "at risk" rules apply in a credit pass-through situation. Some would argue that the rules should apply at the lessor level only, while others would argue that the lessee must meet the requirements. Moreover, if the rules were to apply at the lessee level, it is not at all clear how this would be done. Typically, a lessee would be not have an investment in the property or be liable for amounts borrowed with respect to the property.

Whether intentionally or not, Title III seems to eliminate some of these ambiguities simply because of the changes made in the language of Section 46(c)(8). Section 46(c)(8) as revised by Title III requires that the basis of property for ITC purposes be reduced by any nonqualified nonrecourse financing "with respect to" the property. Such revised rules apply to property placed in service by a taxpayer described in Code section 465(a)(1) and used in an activity subject to the loss limitations thereunder. It would appear that if the lessor satisfies the ITC at risk rules and assuming the lessee incurs no financing with respect to the property, that in effect the ITC "at risk" rules would be satisfied in a credit pass-through situation at the lesser level. Still, it is not clear who the "taxpayer" is for purposes of determining when the ITC "at risk" rules come into play—that is, whether the rules come into play if only the lessee would be subject to Code section 465, if only the lessor would be subject to Code section 465, or in both situations. Also, it is not clear how the special exceptions apply when the lessee's fair market value basis exceeds the lessor's basis. (For example, does the 80 percent limitation on the amount of qualified commercial nonrecourse financing apply with respect to the lessor's or the lessee's basis?)

Recommendation

We recommend that the application of the ITC "at risk" rules in a credit pass through transaction be clarified. In particular, it should be made clear whether it is intended that the rules may be satisfied at the lessor level, in what situations they must be satisfied, and how the special exceptions are to be applied. We believe at a minimum that where the lessor is an individual or entity subject to Code section 465 and the lessor satisfies the ITC "at risk" rules, the rules should be deemed satisfied by the lessee in a credit pass-through situation. We recognize, however, that there are several other situations in which the rules might apply and would be pleased to work with the Committee in developing appropriate rules for all cases.

WASHINGTON, D.C., *July 13, 1983.*

JOHN J. SALMON, Esq.
Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: In accordance with the Committee's press release of July 11, 1983, announcing a hearing on H.R. 3475, "The Tax Law Simplification and Improvement Act of 1983", I request that this letter be included in the printed record of the hearing.

My name is Kenneth W. Gideon. My office address is 1150 Connecticut Avenue, N.W., Washington, D.C. 20036 (Telephone: (202) 452-6800). I am now a partner in the law firm of Fulbright & Jaworski. Before rejoining Fulbright & Jaworski in May, I served for approximately two years as Chief Counsel for the Internal Revenue Service. I am appearing in my personal capacity and not on behalf of any other person or organization.

I will limit my comments to Title VII of the bill pertaining to the United States Tax Court. I urge that every effort be made to include provisions which will directly aid the Court in dealing with its more than 52,000 case docket. Specifically, I would recommend that the Committee consider means to expand the utilization of the Court's small case precedures.

The cases tried under the small case procedures are heard by a special trial judge of the Court utilizing less formal procedures, such as use of affidavits and oral motions, which make it far easier for the pro se taxpayer to present his or her case. Such cases are not appealable, thus there is no need to insist on the formalities required to permit appellate review. Use of these procedures where now permitted has had a substantial favorable impact on the Court's docket. Expansion in a manner that would move virtually all pro se cases into the small case system could shift as much as one-third of the caseload of the Court's regular judges to its special trial judges, thus alleviating the regular docket backlog while providing a trial system better suited to the needs of the vast majority of pro se litigants.

These desirable results could be accomplished, in my judgment, by requiring that all petitions involving less than $5,000 in tax per year be heard under the Court's "small cases procedures" and requiring the same treatment for those involving between $5000 and $10,000 unless the taxpayer specifically opted to have his case placed on the "regular" docket. I strongly urge the Committee to give serious consideration to including such a provision or a similar provision in this bill.

I would also favor inclusion of a "motion out" procedure whereby the Court could, for good cause shown, remove a case from the "small case" docket so that a precedential, reviewable decision could be rendered when the ends of justice would be served. I would expect such motions to be relatively rare. The absence of an appeal in cases remaining on the "small case" docket should not be a serious concern since cases of this size are infrequently appealed by taxpayers, and the "no appeal" feature will protect taxpayers from costly government appeals. Moreover, fully appealable forums in the District Courts and Claims Court are available to taxpayers to whom appealability is a major consideration.

I want to thank the Committee for the opportunity to be heard on this issue and will, of course, be happy to respond to inquiries concerning the proposal contained in my comments.

Very truly yours,

KENNETH W. GIDEON.

STATEMENT OF INVESTMENT COMPANY INSTITUTE

The Investment Company Institute files this comment with respect to Sec. 506 of H.R. 3475, relating to socalled "stapled stock." That section would add a new Sec. 269B to the Internal Revenue Code to provide, among other matters, that, when the stocks of two corporations or other entities are stapled together, the two should be regarded as a single entity in determining the applicability of Subchapter M.

The Investment Company Institute is the national association of the mutual fund industry. Its membership consists of more than 800 mutual funds, their investment advisers and principal underwriters. Mutual funds are "open-end" regulated investment companies, as described in the Internal Revenue Code, the rules for which are provided in Subchapter M, Part A.

Since the introduction of H.R. 3475 the Institute has made inquiries among its members to ascertain whether in fact there are cases in which the stock of a mutual fund has been "stapled" with the stock of any other corporation. Although the inquiry was not exhaustive, the Institute has not been able to find any instance in which this has occurred. We think it unlikely to occur in the case of mutual funds because their shares are not normally bought or sold from one shareholder to another, but are acquired by shareholders on original issue from the company and are sold by tender to the company for redemption. Moreover, it has been customary among mutual funds for some years to forego the issuance of certificates of stock to shareholders unless they request it, and instead to keep a record of share owneship for each shareholder and to send to shareholders periodic statements of their share ownership. In these circumstances, stapling of the stock of the mutual fund with that of another entity would not seem to be feasible, and we know of not instance in with it has it has occurred.

The category of "regulated investment companies" as defined in subchapter M also includes so-called "closed-end" companies; these closed-end" companies are not engaged in the regular issuance and redemption of their share, but their stock is generally traded on securities exchanges or "over-the-counter." It might be possible to staple the stock of a closed-end investment company with that of another entity, although, again, the Institute knows of not instance in which this has occurred.

In these circumstances, while the Institute knows of no cases in which stapled stocks have been used in the mutual fund industry, the Institute has no objection to the enactment of Sec. 269B. We do question, however, whether the proposed Sec. 269B(a)(3) should point solely to Subchapter M in determining whether an entity qualifies under its provisions, without extending the same principle to other subchapters or provisions in the Internal Revenue Code where special rules are applicable to particular types of entities. For example, Subchapter H (relating to banking institutions), Subchapter L (relating to insurance companies), Subchapter S (relating to so-called "S Corporations" and their shareholders), Sec. 1244 (relating to small business corporations), etc., provide special rules for categorizing business entities, and those rules might be circumvented through the "stapled stock" mechanism.

Accordingly, if the "stapled stock" device is to be controlled through the proposed new Sec. 269B, we respectfully suggest that it should apply generally throughout the Code and should not be aimed at Subchapter M alone, particularly when we can find no instance in which the device has in fact been used in the mutual fund industry. Otherwise, the enactment of Sec. 269B(a)(3) solely with respect to Subchapter M might be taken as an indication that the stapled-stock device can be used to circumvent restrictions in other parts of the Code.

We note that the definition of the term "entity" in Sec. 269B(c)(1) includes not only corporations but also partnerships, trusts, etc. However, in Sec. 269B(a)(2) reference is made only to "stock." Consideration might be given to the desirability of adding a definition of the term "stock" to include an beneficial ownership in an "entity."

STATEMENT OF MARSHALL J. LANGER, ATTORNEY, SHUTTS & BOWEN, MIAMI, FLA.

Mr. Chairman and members of the committee: My name is Marshall J. Langer. I have practiced law in Miami for over 32 years and I am presently of Counsel to the law firm of Shutts & Bowen. I specialize in international tax planning, working primarily with foreign clients who invest in the United States. I represent a number of clients who are affected by this proposed legislation, but I have not prepared this statement on behalf of any particular client.

SUMMARY

The following is a summary of my comments and recommendations:

(a) Section 501 contains a much-needed objective definition of resident alien for income tax purposes. I strongly support this concept, but I suggest several changes to eliminate undue harshness of some of the provisions.

(b) Aliens who newly acquire or apply for green cards should still be entitled to dual-status years.

(c) The objective definition of an alien's residence should be reapplied each year without reference to his prior status.

(d) The substantial presence test formula should be based on 241 days (rather than 183 days) in a 3-year period.

(e) There should be a transitional rule under which days prior to 1984 would not be counted.

(f) The requirement of a "tax home" should be eliminated or redefined.

(g) Persons required to remain in the United States for medical reasons should be permitted to qualify as exempt persons.

(h) To avoid penalizing U.S. airlines, time spent in direct transit through the United States should not count as "days."

(i) Dates of entry or dates of departure should be counted, but not both.

(j) New residents should be given a step-up in basis for their capital assets.

(k) Long-term residents who abandon U.S. residence should be subject to the anti-expatriation rules which presently apply only to citizens.

INTRODUCTION

The United States taxes resident aliens and non-resident aliens in totally different ways. After 70 years of income tax, we should have a workable definition of residence for aliens; we don't. There is a popular misconception that an alien who spends more than half the year in the United States is resident, but that one who spends less time in the country is not. There is no such rule.

Thousands of wealthy foreign individuals regularly "visit" the United States for more than six months each year. The IRS doesn't know who they are; if the INS does, it generally doesn't tell the IRS. Their income is from foreign sources and is not taxable if they remain nonresidents. Although many of these "visitors" are really American residents and should be U.S. taxpayers, they don't pay taxes, and they are rarely caught. Two things are needed:

First, we need a workable definition of resident alien based on an objective standard.

Second, the IRS needs information concerning those nonimmigrant aliens who spend more than 120 days a year in the United States. The INS should maintain records showing the number of days each alien is in the United States. Its records should be available to the IRS. An alien who is in the country more than 120 days a year should be required to file an information return with the IRS containing sufficient data to enable the IRS to determine whether or not he is resident for tax purposes. Failure to comply should lead to a loss of visa, and visas should not be renewed without evidence of compliance.

The foregoing summarizes my previous testimony before this and other Congressional committees on the need for a workable definition of residence of aliens based on an objective standard. I commend Chairman Rostenkowski and Congressman Conable for including such a much-needed definition in H.R. 3475. Section 501 contains an objective definition of resident alien for income tax purposes.

While I agree completely with the basic concept of Section 501, I nevertheless wish to suggest several changes, most of which are of a technical nature:

1. Proposed new IRC Section 7701(b)(1)(A)(i) should apply to an alien who acquires lawful permanent residence only from the date on which he acquires such status. The provision seems to override Treas. reg. § 1.871-13 which permits dual-status years. It is unfair for an alien who obtains a green card near the end of the year to be deemed a resident alien retroactively to January 1st of that same year. As in the past, such an alien should be entitled to a dual-status year unless, of course, he is deemed a resident alien under one of the other tests.

2. Essentially the same comment would apply to proposed new IRC Section 7701(b)(1)(A)(ii). The test should be whether the alien is present on at least 60 days during the calendar year, counting only those days beginning on the date on which the application for an immigrant visa is filed.

3. The Committee Report should clarify when an application for an immigrant visa is considered to be pending. For example, an application for an immigrant visa might be deemed to include an application for a preference petition filed by or for an alien individual. Yet, it may take several years before such a petition is granted and a quota number becomes available.

4. New IRC Section 7701(b)(1)(B) clearly implies that the objective definition of an alien's residence should be reapplied each year without reference to his status during the preceding year. Treas. Reg. § 1.871-5 currently provides that once an alien acquires U.S. residence he retains it until he abandons it and actually leaves the United States. To avoid any ambiguity, the Committee Report should expressly indicate its intention to change the existing regulation.

5. The reference to "183 days" in the substantial presence test set forth in proposed new IRC Section 7701(b)(2)(A) is undesirable for several reasons. For many years aliens have had the misconception that the United States has a 183-day residence test. The wording of the substantial presence test is likely to heighten that misconception, particularly for aliens who lack a clear comprehension of the English language. The effect of the test is to permit an alien to be present for 91 days each year without meeting the test. An alien present 92 days or more each year would meet the test. Since many aliens will have difficulty proving closer connection to a foreign country and a "tax home" there to the satisfaction of the IRS, this is probably too low a number. I suggest that the number be changed from 183 days

to 241 days. This would mean that an alien present an average of 120 days would not meet the test, but that we present an average of 121 days or more per year would meet the test. In view of the conditions imposed, the average of approximately three months per year is to short and will sweep up too many vacationers and business visitors. An average of about four months a year would be more realistic.

6. With respect to the substantial presence test, there should also be a transitional rule under which the number of days in years prior to 1984 should not be counted. As written, application of the test during the year 1984 would be based in part on days the individual was present in the United States during 1982 and 1983. This will certainly be perceived by some aliens as being retroactive legislation. Many aliens will not have adequate records to establish the number of days on which they were present in the United States in the years prior to the introduction of this legislation. Under the suggested transitional rule, for 1984 only days during 1984 would be counted. For 1985, days present in the United States during 1984 and 1985 would be counted. Beginning with 1986, the 3-year test would apply.

7. The exception to the substantial presence test contained in proposed new IRC Section 7701(b)(2)(B) is too restrictive. The "tax home" requirement should either be eliminated or redefined. It should be sufficient to require presence less than 183 days during the curent year and closer connection to a foreign country.

What is a tax home in a foreign country? The bill refers to the definition in IRC Section 911(d)(3) which in trun refers to the individual's home for purposes of IRC Section 162(a)(2). It is a confusing term. It has nothing to do with the place at which the alien pays taxes.

Proposed Treas. Reg. § 1.911-2(b), published July 20, 1983, amplifies the statutory definition. It says an individual's tax home is located at his regular place of business. If he has more than one regular place of business, it is located at his principal place of business. If he has no regular or principal place of business then his tax home is at his "regular place of abode in a real and substantial sense." Under IRC Section 911(d)(3) and the proposed regulations, an individual is not treated as having a tax home in a foreign country for any period in which his abode is in the United States. Temporary presence in the United States doesn't necessarily mean that his abode is in the United States. However, that could be interpreted as meaning temporary presence without a temporary abode.

The use of the word abode is unfortunate. It apparently doesn't have any special meaning under the Internal Revenue Code. The dictionary says it is a "residence or place of residence; home; a place where a person abides; a dwelling; habitation." There is at least some inference that an individual can have both a permanent abode and a temporary abode. It is not clear whether the existence of a vacation home or temporary abode in the United States may preclude the finding of a tax home in a foreign country.

The tax home concept was originally designed to determine when a taxpayer was "away from home" so as to permit him to deduct business expenses. If a taxpayer cannot prove that he has a tax home he is considered to be an itinerant who has his home wherever he happens to be working. Thus, he is never "away from home" and never gets a travel expense deduction.

More recently the tax home concept was extended to deal with a U.S. citizen who lives and works abroad. Such an individual may qualify to exclude certain portions of his income from U.S. taxation. To qualify, the citizen must prove that he is a bona fide resident abroad or that he is physically present abroad for approximately 11 out of 12 months. In addition, he must have a tax home in a foreign country. The tax home concept probably works there because it correctly contemplates that a qualified individual will be present abroad virtually full time.

Here, however, we are working with an exception to the substantial presence test. The exception is meaningful only to an alien individual who is present in the United States for an average of more than 91 days per year. Otherwise he wouldn't meet the substantial presence test and wouldn't need the exception.

From my experience, alien individuals who are present for 3 to 6 months per year invariably have one or more vacation homes or temporary abodes in the United States. Such persons should not be required to stay in hotels or other transient facilities in order to qualify for exemption from the substantial presence test. The bill in its present form appears overly restrictive.

If the "tax home" requirement cannot be eliminated, it should be amended by eliminating the cross reference to IRC Section 911(d)(3). The Committee Report should expressly permit an alien individual to maintain one or more vacation homes or temporary obodes in the United States as long as he also maintains his principal abode in the foreign country.

8. The category of exempt individual as set forth in proposed new IRC Section 7701(b)(3)(A) should be expanded to include an alien who is required to remain in the United States for medical reasons. Many older individuals come to the United States for medical treatment. Extended hospitalization may result in their unexpectedly spending more than 182 days in the United States in a given year. To prevent abuse of such a provision, however, there should be a limitation similar to that applied to teachers and trainees under proposed new IRC Section 7701(b)(3)(F)(i). It should not be possible to use the medical exemption more than twice in any 6 years (once in any 3 years).

9. The rule for counting days of presence in the United States set forth in proposed new IRC Section 7701(b)(6)(A) presents a problem for persons who travel from Europe to Latin America through Miami or New York. Some planes for South America leave late at night, occasionally even after midnight. An in-transit passenger may be deemed to have spent 2 days in the United States while merely in transit. An exception should be provided for persons in transit through the United States while in transit without visa [TROV] status for immigration purposes.

The American Bar Association's legislative recommendation on this subject has suggested an alternative approach which I also consider acceptable. Under it, a day would not be counted if the alien was outside the United States at both the beginning and the end of the day.

Counting days spent in-transit through the United States will almost certainly have a detrimental impact on the revenues of U.S. international airlines. Aliens who are "close to the line" under any of the tests will use foreign carriers to fly around rather than through the United States.

10. It would also be fairer to count either dates of entry or dates of departure, but not both. This was the rule adopted by the Tax Court in *Martin Tow* v. *Commissioner*, 36 T.C. 861 (1961). The Commissioner nonacquiesced in this decision and subsequently issued contrary regulations. See Treas. Reg. § 1.871-7(d)(3)(ii). However, in a recent decision, the Tax Court again counted dates of entry but not dates of departure. See *Tongsun Park* v. *Commissioner*, 79 T.C. 252 (1982).

11. Congress should mandate some form of required coordination between the INS and the IRS to insure enforcement of the new rules. Aliens leaving the country should be required to set forth the number of days they have spent in the United States during the year. Information concerning those spending more than a certain number of days in the United States should be communicated from the INS to the IRS. Similar information should be obtained in connection with applications for renewal of visas. An alien seeking to renew a visa should be required to furnish evidence of compliance with the rule requiring annual statements set forth in proposed new IRC Section 7701(b)(7).

12. As a result of this proposed legislation, there are likely to be a large number of new resident aliens for tax purposes. The Committee should therefore also consider changing the present unfair rule under which capital gains derived by resident aliens are determined by reference to historic cost even if the property was acquired many years before the alien moved into the United States. This rule should be changed to provide for revaluation of assets as of the date the alien becomes a U.S. resident.

Aliens terminating residence in the United States after a period of residence of five years or more should be made subject to the anti-expatriation rules set forth in IRC Section 877 which presently apply only to citizens. There is no valid reason for treating long-time resident aliens differently than U.S. citizens. The special anti-expatriation rules of IRC Section 877 should also be amended to make them applicable for five years instead of 10 years as at present.

CONCLUSION

In conclusion, I urge the prompt enactment of Section 501, hopefully with the modifications I have suggested. I would be pleased to respond to any questions the Committee or its staff may have.

NATIONAL ASSOCIATION OF ENROLLED FEDERAL TAX ACCOUNTANTS

Chicago, Ill., July 28, 1983.

Re: Title VII, Tax Court Provisions.

Committee on Ways and Means,
U.S. House of Representatives, Washington, D.C.

GENTLEMEN: This is a brief statement for the printed record in connection with your Hearings on H.R. 3475, introduced on June 30, 1983.

We would appreciate a little extension of time to submit further details on the following comments: (Please contact us on this point).

We are in favor of the amendment to Section 7463 which would permit an IRS "enrolled agent" to represent taxpayers in disputes involving $5,000.00 or less. However, this should not be tied to the elimination of the written exam for nonlawyers who wish to practice in the full, regular Tax Court cases.

We object to the amendment to Section 7452 which would eliminate the written exam on a number of points. Those who have already taken this exam once are entitled to take it two more times, and if it is eliminated in 1984 and thereafter, it would harm those who have the right to take it one or two more times. By stopping the written exam you will be creating a dying-class of about 130 practitioners who have already passed the exam since about 1942.

The amendment to Section 7463 is a separate issue from the amendment to Section 7452 and should not be done at the same time.

The bill, H. R. 1540, introduced on Feb. 17, 1983 by the Hon. Leon E. Panetta, of California, would correct a significant problem relating to representation of taxpayers before the U.S. Tax Court, without amending Section 7452, but would only amend Section 7463 concerning a less formal procedure for Tax Cases involving sums of $5,000.00 or less.

Attached for the printed record, also, is a reprint of the part we have played in the IRS Teaching Taxes Program for more than 20 years. Please let us hear from you soon.

Cordially,

S. A. Rish, E.F.T.A.
Executive Director.

National Association of Enrolled Federal Tax Accountants

For *17 Consecutive Years* we have participated in the Internal Revenue Service Teaching Taxes Program and are listed in their *1979 Edition of Publication 21:*

UNDERSTANDING TAXES, 1979

Explanations and examples in Understanding Taxes reflect the official interpretation by the Internal Revenue Service of tax laws enacted by Congress, regulations issued by the Treasury Department, and pertinent court decisions. There are, however, some matters covered in the publication on which certain courts have taken a position more favorable to the taxpayers than the official position of the Service.

Until these varying interpretations are ultimately resolved by higher court decisions, or otherwise, we must necessarily continue to state the Service viewpoint. Readers are also reminded that they have appellate rights within the Service and that they may appeal to the courts in those cases where they do not agree with positions taken by the Service. These appeal procedures are outlined in Publication 556, Examination of Returns, Appeal Rights, and Claims for Refund.

For further information about job opportunities in tax accounting, you may write to the following associations: American Institute of Certified Public Accountants, New York, N.Y. The National Society of Public Accountants, 1717 Pennsylvania Avenue, N.W., Washington, D.C. 20006; the American Woman's Society of Certified Public Accountants, 327 South La Salle Street, Chicago, Ill. 60604; the National Association of *Enrolled Federal Tax Accountants.*

NICE TALKING TO YOU

Between January and April, 1978, when tax returns were being prepared and filed, IRS answered nearly 18,000,000 telephone calls on tax questions (an average of 25,000 each working hour). If these calls, averaging 3½ minutes each, were made as one call, that call would last nearly 120 years, from the first "Hello" to the weary "Good-bye."

TAXING CIRCUMSTANCES

In the 1700's, a group of southwestern Pennsylvania farmers were so incensed over the "obnoxious" tax on their whiskey that they ignited the Whiskey Rebellion of 1774. At least one revenue collector was tarred and feathered; and not until President Washington called up Federal troops was the trouble quieted.

PAPER AND INK

Look what it takes to print IRS tax forms each year. To print nearly 41 million copies of IRS' 24-page package of Short Form 1040A and its instructions, a midwestern printer used 105 boxcars of paper—3.9 million pounds—and one-quarter million gallons of ink. The contract award was the largest single printing job order in the company's 94-year history.

FISHING TACKLE TAX

Nothing "Fishy" here. Did you know that tax money received from the sale of fishing tackle is collected by IRS, then transferred to a fund administered by the Department of the Interior where it is put to use in aiding sport fishing?

NATIONAL ASSOCIATION OF ENROLLED FEDERAL TAX ACCOUNTANTS,®
Chicago, Ill., July 29, 1983.

Re: Printed Record on Hearings on H.R. 3475, Title VII, Tax Court Provisions.

Committee on Ways and Means,
U.S. House of Representatives,
Washington, D.C.

GENTLEMEN: Please associate these comments with my letter of July 28, 1983, mailed yesterday.

The wording on Page 73, Line 15 should be amended to read: "(1) a certified public accountant qualified under Public Law 89-332, or".

This amendment is needed to make it perfectly clear that a "certified public accountant" must be "duly qualified to practice in their State jurisdiction". Many CPAs are not Licensed in their State and are therefore Not qualified to practice before the IRS.

Without this amendment CPAs who are not State Licensed could be allowed to represent taxpayers before the U.S. Tax Court even though they are Not authorized or recognized to practice before the IRS.

I trust this will be combined with my comments of yesterday for inclusion in the Printed Record, and that a copy of the Hearings Record will be mailed to me.

Cordially,

S. A. RISH, E.F.T.A.
Executive Director.

NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES,
Washington, D.C., August 4, 1983.

DEAR MEMBER OF THE COMMITTEE ON WAYS AND MEANS: On behalf of the National Association of Independent Colleges and Universities, which represents over 800 independent colleges and universities across the country, we would like to respond to Title IV of H.R. 3475, "The Law Simplification and Improvement Act of 1983." We ask that this letter be made a part of the record for the July 25 hearing before the Committee on Ways and Means.

We are very pleased that Chairman Rostenkowski and Representative Conable have introduced this legislation to adopt a permanent rule permitting reformation of charitable trust instruments which fail for technical reasons. Since the 1969 Tax Reform Act when the original rules were implemented, college and university development officers have struggled with some very complex and technical requirements. This legislation would alleviate many of those difficulties; for that, colleges and universities are grateful and we applaud your efforts.

Although generally pleased with the provision of the bill, there are a few issues that we would like to address:

1. The bill addresses only charitable remainder trusts under Section 664 of the Internal Revenue Code. We suggest that it also include both charitable lead trusts and pooled income funds under Section 642(c)(5) of the Internal Revenue Code. Although not as numerous as charitable remainder trusts, development officers have experienced similar problems with lead trusts and pooled income funds. In addition, the bill should make clear the tax-exempt status of the reformed charitable remainder trust, charitable lead trust, and pooled income fund.

National Association of Enrolled Federal Tax Accountants,® A Collective Membership Mark, Registered in the U.S. Patent and Trademark Office.

2. In the June 30, 1983 Congressional Record, page H 4884, the general explanation of the bill states that "the bill would permit the period of limitations to be reopened until December 31, 1985, to allow tax benefits to accure for otherwise closed estates . . ." This provision does not appear in Section 401 of the bill.

3. The bill would require that the actuarial values and duration of the charitable and noncharitable interests in the trust generally remain the same before and after the reformation. (An exception is provided for charitable remainder trusts established for a duration of longer than 20 years, which may be reformed to last for 20 years.) We do not believe there is any need for a reformable interest to be expressed either in the form of a fixed percentage of the fair market value of the property or in the form of a specified dollar amount. Many minor defects, which may be the sole reason for the trust's failure to qualify, are impossible to value by accepted methods. We, therefore, recommend that this unnecessary requirement be eliminated.

4. The bill seems to provide that instruments drawn after 1978 could not be reformed if they do not meet the 1969 Act requirements. As we understand it, this means that even if post-1978 trusts fail for technical reasons only, they will not be reformable. A substantial number of charitable remainder trusts, lead trusts, and pooled income funds were drafted after 1978, and because of technicalities, would probably fail. We agree that an intent to comply with the 1969 rules should be essential, but failure for technical reasons alone is unduly restrictive. We suggest that the 1978 cut-off date be extended to December 31, 1983.

Again, we thank you for your work on this issue of great importance to deferred giving programs at colleges and universities.

If you have any questions, please do not hesitate to call.

Sincerely,

KATHLEEN CURRY,
Legislative Representative.

STATEMENT OF THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC.

INTRODUCTION

This statement expresses the serious concern of the National Association of Real Estate Investment Trusts, Inc. ("NAREIT") and the REIT industry regarding provisions of section 506 of H.R. 3475 that affect the status and operations of so-called "stapled-stock" REITs. NAREIT is the sole trade association representing the industry and has among its membership 75 "tax qualified" real estate investment trusts with assets of $5.5 billion, comprising nearly 80 percent of the assets of all qualified REITs.

SUMMARY OF POSITION

Provisions of Section 506 of H.R. 3475 would treat as one entity, commencing January 1, 1985, domestic entities whose stock was "stapled" on June 30, 1983, for the purpose of determining whether one of the entities is a real estate invesment trust as defined in section 856, et seq., of the Internal Revenue Code of 1954 (Code).

It seems evident that the principal purpose of section 506 is to eliminate opportunities for U.S. corporations to avoid the controlled foreign corporation and international boycott provisions of the Code. We believe that there is no comparable abuse in the REIT area. Moreover, in view of the unique policy underlying the restrictions of the REIT tax system, the REIT stapled-stock issue is inappropriate in the context of H.R. 3475. For these reasons, we urge the Committee to exclude stapled-stock REITs from the scope of section 506.

We are also deeply troubled by the drastic effect of this proposed legislation on the operations and the interests of a significant segment of the REIT industry and thousands of investors that have relied on specific Internal Revenue Service rulings approving the stapled interests involved. If enacted, this legislation would require stapled REITs to either discontinue REIT status or sever the stapled relationship. In either event, investors in some of these entities may experience adverse consequences. For this reason, and because most of the stapled-stock arrangements involving REITs have been specifically approved by rulings of the Internal Revenue Service, we believe that the only equitable approach to such a fundamental legislative change, if it is necessary, would be to exclude permanently all existing stapled situations involving REITs.

BACKGROUND

The attached table details the REITs affected by H.R. 3475, their total assets, the number of shares of stock outstanding, and the years in which their stapled-stock arrangement were established. NAREIT believes that the information provided accurately reflects industry conditions, given its two-decade history of comprehensive study and reporting of industry activities.

As noted in the attachment, the combined assets of affected REITs represent some 18.5 percent of the gross book assets of the entire industry. We would further note that approximately 25,000 shareholders have interests in these REITs. A number of these shareholders are major pension plans that hold shares for the benefit of perhaps millions of individual beneficiaries.

The initial stapling of REIT shares was effected in 1972. Carried out purusant to a favorable IRS private letter ruling issued in 1971, the stapling, involved the creation of a trust to which an existing REIT transferred shares of a newly-organized leasing company. The shares of the stapled entity are held for the benefit of the shareholders of the REIT. Income of the corporation is subject to normal corporate tax and dividends distributed by the trust to its beneficiaries are, of course, taxable as ordinary income.

The second REIT stapled arrangement was created in 1977 and substantially resembles its predecessor in that an existing REIT established an entity with the expectation that shares in the entity would be held by REIT shareholders beneficially through a separate trust. A favorable IRS ruling imposed certain additional conditions, including a requirement that the REIT distribute the shares of the stapled entity directly to the shareholders who in turn could at their election place the shares in the stapling trust.

Subsequent stapled-stock arrangement took a different form. Generally, the existing REIT or other corporation caused the formation of a separate taxable corporate entity and entered into an agreement with the new entity to restrict the transfer of respective shares so that the shares of the entities were traded as a single investment unit. The stapled unit were distributed pro rata to the shareholders in the first entity in exchange for their stock in that entity. The IRS rulings characterized the final transaction as constituting a taxable dividend to the shareholders to the extent of the value of the newly-organized stapled entity.

With one exception, these stapling arrangements were effected to permit segregation of qualifying REIT activities from nonqualified active business operations which were to be undertaken by the stapled entity. The stapling arrangement was vital to assure the ownership continuity for shareholders while avoiding possible conflicts of interest in the operations involving the stapled companies.

The exception involves a REIT that was extensively engaged in the leasing of hotel properties. In a departure from longstanding industry practices, numerous major hotel operating companies such as Marriott, Hilton and Sheraton because unwilling to enter into long-term leases with independent owners of hotels such as the REIT. These operating companies instead sought long-term management agreements that protected the operators from losses. The shift from leasing and management agreement was crucial, because income restrictions of the REIT tax regime precluded REITs from operating hotels under management agreements. In view of the extreme difficulty in obtaining lease agreements, a stapled entity was created to lease some of the REIT's hotels.

REIT STAPLED STOCK SHOULD BE EXCLUDED FROM H.R. 3475

In introducing H.R. 3475, Chairman Rostenkowski described the purpose of section 506 as follows:

> Finally, this title contains provisions to deal with a longstanding problem regarding so-called stapled stock. In several instances, U.S. corporations have attempted to avoid the subpart F rules and the antiboycott rules by splitting off their foreign operations and conducting them through separate corporations. In these cases, the stock of the two (or more) entities is "stapled" of "paired" so that a shareholder cannot trade the stock separately. The management of the two companies may be the same.
>
> The bill would provide generally that where a foreign and domestic corporation are stapled entities, the foreign corporation would be treated as domestic. In addition, stock in a domestic corporation which constitutes a stapled interest with respect to stock of another domestic corporation would be treated as owned by the latter corporation. (Congressional Record June 30, 1983, page H4881.)

Under subpart F, certain income of a foreign affiliate of a U.S. corporation is taxed to the parent corporation as if distributed as a dividend. The deemed distribution under subpart F can be avoided if the stock of the foreign affiliate is distributed to the parent corporation's public shareholders. Tax under subpart F is avoided because the foreign subsidiary is no longer an affiliate of the parent but is, after the distribution of its shares, owned by public shareholders who are not subject to tax under subpart E. The effect of this arrangement is to assure that there will be no U.S. tax until the foreign subsidiary earnings are actually distributed to shareholders.

By contrast, stapled interests of REITs do not involve tax avoidance by either stapled entity. The Technical Explanation of H.R. 3475 describes the different issues in the REIT context as follows:

> In addition, stapling of stock of two or more domestic corporations could allow shareholders to benefit from multiple surtax exemptions and from mutliple accumulated earnings tax credits. In addition, companies may split off certain investments into a separate company that will qualify for special tax treatment, such as Real Estate Investment Trust, (REIT) or Regulated Investment Company (RIC) benefits. This special treatment would not be available if the companies were consolidated.

There is no problem of multiple surtax exemption or multiple accumulated earnings tax credits involved in a REIT. The nonREIT activities of the stapled company are subject to a tax to the same extent as they would be if the two entities were owned separately. Income of the REIT is qualified income for purposes of section 856. To the extent that any tax problems exist in such a situation, they relate to the fairness of the transactions between the two entities. Indeed, this was a factor addressed in the specific conditions of several IRS rulings. New legislation is not needed to enable the IRS to control a possible abuse in this area, as there are adequate restrictions under section 482 of the Code and other existing laws to asure that amounts of income and deductions are fairly allocated between the two entities. The REIT tax provisions are adequate to assure that income allocated to the REIT is qualified income.

Even if the adequacy of existing protections is in serious doubt, restrictions on the use of stapled interests by REITs do not belong in this proposed legislation. If a statuory amendment is necessary, we believe that such legislation should be considered in the context of an independent review of the REIT rules. Effective as of February 17, 1981, the IRS indicated that it would no longer issue rulings under section 856 on the formation of stapled interests involving REITs where "the activities of the corporations are integrated." See Rev. Proc. 81-4, 1981-1, C.B. 619. The IRS has not elaborated further on the problem which it perceives to exist in this area. However, this "no ruling" policy should adequately protect the IRS from the effect of any structural problems that might exist under present law, pending such an independent review.

Furthermore, the size and sophistication of the real estate industry in which REIT's compete has expanded immensely in recent years. The flow of investment Capital into the industry has been fundamentally if not radically altered by the explosive growth of real estate limited partnerships and increased presence of institutional investors such as pension plans. In this environment, the operational constraints and other conditions for REIT activities are placing REIT's at a competitive disadvantage that frustrates growth and the interests of present and future REIT investors. The REIT industry has been plagued recently by piecemeal legislation affecting REIT's, such as that in section 506, enacted without careful consideration of the broader implications in an intensely competitive, difficult, economic environment. We believe that stapled stock and other tax issues relating to REIT's should be considered independently of these proceedings.

EXCLUSION OF EXISTING STAPLED REIT'S

If the Committee perceives actual or potential abuse in the REIT area that in fact justifies prohibition of stapled REIT's within the context of H.R. 3475, we strongly believe that the Committee should find that no reasonably perceived abuse warrants application of the new law to existing stapled REIT's. It is simply inequitable to cause these REIT's to destaple or otherwise reorganize given the harm that may be suffered by investors and the industry's reliance on and continued compliance with favorable IRS rulings.

ADVERSE CONSEQUENCES TO REIT INVESTORS

Under the proposed amendment, the REIT and the stapled company would be treated as a single entity for purposes of determining REIT qualification under section 856 of the Code. To avoid the possible penalties of disqualification to REIT would have to revoke its REIT status no later than 90 days after the first day of the first taxable year for which the revocation is to be effective, as required by section 856(g)(2). Alternatively, disqualification could be avoided by severing the stapled relationship prior to the effective date of the law, January 1, 1985. Either of these steps would result in fundamental changes in the investment held by existing shareholders, with the type and degree of harm varying depending on the particular REIT's and stapled companies involved.

Without the special tax treatment of the REIT's income, the anticipated return on the shareholders' investment would almost certainly be reduced significantly. Obviously, terminating REIT status will not be a feasible alternative for a REIT and its shareholders, many of whom may be either long-term or recent purchasers of shares who specifically relied upon anticipated benefits of continued REIT qualification.

Termination of the stapled arrangement does not offer a much better choice. While REIT status would continue, operation of the companies as separately owned independent entities under separate direction would eliminate the advantages of continuity and stability in the relationship between the two operations. The value of this continuing relationship would very likely be reduced if the stapled interests are severed. At this time, it is difficult to evaluate the extent of the devaluation which will occur if the stapled relationship must be terminated. The proposed legislation has appeared so unexpectedly that NAREIT and affected REIT's have not been able to assess the potential damage of separation. However, our initial analysis as well as the preliminary assessment of some of the individual REIT's involved, indicates that the damage to some investors could be substantial and possibly irreparable. In the particular case of pension trust investors, the loss will be immediate and unavoidable as trust indentures or applicable law may compel disposition of securities that become unlisted or unrated.

RELIANCE ON SUBSTANTIAL RULING HISTORY

As indicated earlier, REIT's adopting the paired trust arrangements have relied on and complied with IRS private rulings issued more than six and eleven years ago, respectively. In addition, several of the rulings issued to taxpayers adopting the stapled corporation format included the following conclusion by the IRS:

> In the instant case, [Operating Company] is a separate corporate entity that should be recognized under the principle of *Moline Properties* v. *Commissioner,* 319 U.S. 436 (1943). Although the shareholders of [REIT] will benefit from the concurrent ownership of shares of a real estate investment corporation (REIT) and [Operating Company], a business not subject to the REIT restrictions of the Code, this benefit cannot be held to be that of [REIT]. Control of [Operating Company] is in the hands of the [REIT] shareholders who own the [Operating Company] stock and is not exercisable by [REIT]. [Operating Company] is subject to tax subject to risk of loss, can make profits other than through tax savings and has a business purpose.

Taxpayers could reasonably rely on the foregoing as evidence that the IRS duly considered and resolved the crucial question of whether the REIT and its entity were separate entities for tax purposes. In addition, the Joint Committee on Taxation staff indicated in its July 25, 1983 study of H.R. 3475 that "there is authority that would tend to support the integrity" of stapled entities, citing Rev. Rul. 54-140, 1954-1 C.B. 116.

Thus, it can be fairly said that long-standing ruling authority has sanctioned the stapled-stock form of doing business. This authority should not be reversed without a careful consideration of the extent to which the REIT's, their investors, and others have made long-term financial commitments in reasonable reliance on such authority. Upon such consideration, and in view of the absence of tax avoidance such as in the foreign stapled-stock area, principles of fundamental fairness dictate that proposed section 506 should, if enacted, be made inapplicable to existing stapled REIT's.

There is clear precedent for a provision which would grandfather existing REIT's. We note for example that the Tax Equity and Fiscal Responsiblity Act of 1982 adopted carefully crafted effective date limitations on the application of new restrictions on corporate mergers and acquisitions and excluded situations with respect to which the taxpayer had relied on a favorable IRS ruling. Moreover, section 859 of the Code, which requires that REIT's adopt calendar year accounting periods, does not apply to an entity which was considered to be a REIT for any taxable year beginning on or before October 4, 1976. (Accord, I.R.C. Section 1378 re S Corporations.)

CONCLUSION

We urge the Committee to drop the stapled-stock restrictions applicable to REIT's as irrelevant to the subject of section 506 and title V. We believe that, if a problem exists in connection with stapled REIT's, it should be considered in the context of an independent review of the REIT tax regime. Furthermore, if changes are necessary, they should in all events be made prospectively only, excluding existing stapled REIT's.

STAPLED STOCK REIT'S AFFECTED BY H.R. 3475, SECTION 506

REIT and date of valuation	Gross books assets in millions	Number of shares outstanding	Date of stapling
California Jockey Club, San Mateo, Calif.[1] (12/82)	$13.5	2,376,000	1983
Corporate Properties Investors, New York, NY (12/82)	859.0	[3] 8,670,000 [4] 33,000	1977
First Union Real Estate Investments, Cleveland, Ohio (12/82)	532.7	10,312,000	1972
Hollywood Park REIT, Los Angeles, Calif.[1] (12/82)	38.5	3,068,966	1982
Hotel Investors Trust, Chevy Chase, Md. (8/82)	91.3	2,619,842	1980
Santa Anita Realty Enterprises, Inc., Los Angeles, Calif. (12/82)	89.9	6,169,909	1980
Wincorp Realty Investments, Inc., Inglewood, Calif. (2/80)	14.2	1,198,362	1981
Total	[2] 1,639.1	34,448,079	

[1] To the best of NARET's knowledge, these REIT's have not as yet obtained IRS rulings on stapled-stock issues.

[2] Approximately 18.5 percent of total REIT industry book assets of $7.7 billion. Actual market value of assets may be substantially higher.

[3] Class A.

[4] Class B.

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS,
Washington, D.C., August 17, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, House Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This is to provide, for the record, the views of the National Association of Wholesaler-Distributors on H.R. 3475, the Tax Law Simplification and Improvement Act of 1983," particularly Titles III and VIII.

NAW is a federation of 120 national commodity line associations, which in turn are composed of over 45,000 merchant wholesaler-distributors located throughout the 50 states. Wholesale distribution is a major segment of the United States economy with sales forecast by the United States Department of Commerce to reach over $1 trillion this year. The industry provides employment to over 5 million individuals. Our membership accounts for approximately 60 percent of industry sales and employment.

NAW members distribute virtually every conceivable type of consumer and industrial product. They purchase goods from manufacturers and resell them to retailers and to industrial, institutional, commercial and other types of business users, as well as to government.

The majority of this merchandise passes throught the wholesaler-distributor's warehouse to the customer in its original form without the package being opened. A small proportion of the merchandise which our members distribute is assembled before shipment or modified to customer's specifications. Wholesaler-distributors in certain commodity-lines also perform installation, and/or subsequent servicing activities.

A significant portion of the merchandise which our members sell is direct-shipped from the manufacturer to the customer without ever passing through the distributor's warehouse.

Despite the impressive aggregate statistics related above, the wholesale distribution industry is preponderantly composed of small to medium size businesses. The average NAW members' sales volume is approximately $5 million, and has between

40 and 50 employees. It is through this size of business that the vast bulk of products move to market in our economy.

Any effort at tax simplification deserves the support of business and we support the effort to simplify business credits by combining existing credits into and allowing carrybacks and carryforwards of that credit plus additions.

We also support uniformity of the carryover provisions of the Act for business related credits. However, we cannot support the attempt at revision of the at-risk rules. To say the least, the present at-risk provisions are unworkable and a burden on business as well as individual taxpayers. The suggested provisions of the Act do little or nothing to remedy this situation. The entire at-risk concept deserves review and the provisions of H.R. 3475 will further obfuscate an already complex situation rather than simplify or ease the burden imposed on business.

We appreciate the opportunity to submit our views on this very significant issue.

Sincerely,

JOHN H. FITCH, Jr.,
Vice President, Government Relations.

STATEMENT OF THE NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

The National Society of Public Accountants [NSPA] appreciates this opportunity to express its views on H.R. 3475, the "Tax Law Simplification and Improvement Act of 1983."

NSPA is a professional membership association representing over 17,000 independent practicing accountants throughout the United States. The Society also has an affiliated state organization in each of the 50 states, the District of Columbia, and the Commonwealth of Puerto Rico. The members of NSPA provide auditing, accounting, tax, and management advisory services to individuals, small businesses, and local governmental entities across the nation.

The NSPA Federal Taxation Committee, which reviews all proposed tax legislation, has not yet had time to analyze H.R. 3475 in full detail. We hope to submit to the members of this Committee our views on the entire bill within a few weeks. At this time, we will limit our comments to Title VII, which deals with the Tax Court. This Title is of particular interest and concern to our members.

NSPA strongly supports Section 701(a), the provision that would enable enrolled agents and certified public accountants (CPAs) to represent their clients before the Small Tax Case Division of the U.S. Tax Court. There is no reason for denying these practitioners the right to so represent their clients. Small tax cases are heard on a relatively informal basis. Individual taxpayers may represent themselves and rules of evidence are not applied in these cases, as they are in larger ones.

Many taxpayers who obtain outside assistance in the preparation of their returns employ enrolled agents or CPAs. If they become involved in Tax Court litigation, they must then hire an attorney or risk representing themselves. In cases where the amount involved is less than $5,000, it is disproportionately expensive for the taxpayer to hire an attorney. In fact, many times, an attorney does not want to take on such a small case and will, instead, merely urge the taxpayer from pursuing his right to have his case heard.

It really makes no sense to require the taxpayer to either hire an attorney or risk representing himself. Why should the taxpayer be forced to pay legal fees to an attorney, who is completely unfamiliar with the case, when the enrolled agent or CPA who prepared the return already knows what tax rules were required for its preparation and is eligible to defend the return before the highest administrative levels of the IRS?

Allowing enrolled agents or CPAs to represent their clients before the Small Tax Case Division would greatly simplify and expedite the resolution of the taxpayer's claim. Enrolled agents possess an expertise in taxation and are fully able to present the merits of the case. In addition, Section 701(a) will increase the taxpayer's options for selecting a professional to represent him.

NSPA opposes Section 701(b), which would eliminate the examination given by the Tax Court to non-attorneys who wish to practice before the regular division of the Court. While we are aware of how few people take this exam, subsequently pass it, and then seek to represent their clients in the Court, we still believe the examination should be maintained. Increased restrictions on who can represent a client in Tax Court will unnecessarily limit the taxpayer's opportunity to be represented by the professional of his choice.

It is our view that non-lawyers, who qualify by passing the examination, should continue to retain the privilege of representing their clients before the regular division of the Tax Court. Taxation is a highly specialized area of the law. Just as non-lawyers may qualify to represent their clients before the Patent Office—another highly specialized area of practice, so they should be given the opportunity to qualify to represent their clients before the Tax Court.

Another point to consider is the unique status of the Tax Court. The Tax Reform Act of 1969 changed the status of the Tax Court from "an independent agency in the Executive branch" to a "court of record" under Article I of the Constitution. While the 1969 Act clarified somewhat the status of the Tax Court, it left unanswered a multitude of other questions regarding its position. For example, the Tax Court is not under the Administrative Office of the Federal Courts, as are other U.S. Courts. In addition, its decisions are not directly enforceable—the Commissioner of Internal Revenue must assess the tax and institute a suit for collection in the U.S. District Court.

NSPA wishes to thank this Committee for including Section 701(a) in H.R. 3475. We believe that permitting enrolled agents and CPAs to represent their clients before the Small Tax Case Division will benefit the Court and the taxpayer by allowing the expeditious resolution of cases in the most cost effective manner.

We respectfully ask the Committee to reconsider the decision to eliminate the Tax Court examination. Though we understand some to the reasoning behind this decision, we hesitate to endorse a restriction on which qualified professionals can represent their clients before this highly specialized and unique court.

STATEMENT OF THE NEWSLETTER ASSOCIATION PRESENTED BY FREDERICK D. GOSS, EXECUTIVE DIRECTOR

SUMMARY

Recommend the text of H.R. 2659 be added to H.R. 3475 as a technical amendment to amend the Internal Revenue Code of 1954 to repeal the treatment of the deduction for circulation expenditures as an item of tax preference.

The Newsletter Association is the international non-profit trade association representing the interests of publishers of newsletters and specialized information services. The 800 members of the association currently publish some 2,000 newsletters covering almost every conceivable business and consumer subject area.

The Newsletter Association would like to draw the attention of the Committee to an inequity in the tax code created by the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) in its treatment of unincorporated newsletter publishers and to suggest a remedy, which would, in fact, simplify the tax code.

TEFRA amends Section 57(a) of the Internal Revenue Code of 1954 to treat "circulation expenditures" of unincorporated publishers as a tax preference item and subjects these expenditures, after provision for deduction, to the alternate minimum tax of 20 percent. The Newsletter Association understands that the purpose of TEFRA was to raise additional revenues for the Federal Government and quite readily concedes that no individual or group likes to pay additional taxes. However, we believe we can fairly demonstrate that the particular tax application of TEFRA in treating circulation expenses of unincorporated publishers as a tax preference item is illogical and unjust:

First. We find it illogical to tax newsletter publishers on their selling expense. Quite probably better than 95 percent of all newsletter subscriptions are sold by direct mail advertising, (treated as a circulation expense by TEFRA). No other business, to the best of our knowledge, is taxed on their selling expense; not car dealers, not video game manufacturers, only publishers.

Second. Amending Section 57(a) of the IRS Code of 1954 to create this tax preference item, appears to directly contravene the intention of Section 455 of the Internal Revenue Code which permits publishers to use accrual accounting methods and treat their unfilled subecriptions as a liability item. This provision in the IRS Code offers some attractive tax advantages to newsletter publishers in the early years of their operation. It has been a very great incentive to formation of new enterprises and small business. If the intent of Congress is to restrict this opportunity, we suggest that amendment of Section 455 would have been the logical method to pursue. The Newsletter Association also suggests a reading of TEFRA indicates an inadequate understanding of the economics of the publishing business. Under TEFRA, unicorporated publishers are given two options: (1) continue to treat as circulation expenditures as a current year expense, as at present, and paying the tax preference minimum tax as applicable, or (2) capitalizing the expense and incurring it over a life of 10 years. We presume this period was selected in an effort to match treatment of expense with income generated over this period. This presumes an overall subscription renewal rate of about 90 percent, far above the real-life experience of publishers; a period of 3–5 years would be more realistic in terms of actual newsletter publishing operations.

Newsletter publishing is a high-risk business. The Newsletter Association estimates that about 50 percent of all newsletters launched fail, usually within the first year. For newsletters launched by new enterprises, without the expertise and capital of an established firm to support them, the casualty ratio is higher. For a new newsletter venture, promotion (circulation expense), is usually the largest single cost. Commonly, publishers have to spend more than 100 percent of the first year's revenue to acquire a subscription. They do this in hope of delivering a quality editorial product which will result in satisfactory renewal rates and profits in later years. Eliminating, as TEFRA does, the ability to effectively defer realization of income on the subscriptions sold will make an already difficult business that much more treacherous. We submit that TEFRA's application will have an unitended chilling effect on the establishment of new specialized publishing businesses and restrict, to some extent, the flow of information in the United States.

However, our largest objection to the provisions of TEFRA is that they are inequitable. They apply only to unincorporated newsletter publishers. The very largest firms in publishing, newsletter and other types, which are incorporated, are not affected. Why should an unincorporated publisher, normally small and much newer in the business, be subject to a tax which the coroprate giants of the industry are not?

Initially it would appear that unincorporated publishers could solve this dilemma by incorporating, but this is not a simple a solution as seems initially apparent. We suggest that one of the stated purposes of revision of the tax code in recent years has been to eliminate corporation set up solely for tax reasons. The enactment of TEFRA will create a number of such corporations in the newsletter business. Secondly, publishers who have been operating as a sole proprietorship basis will find, if they investigate incorporation, that the amounts of deferred subscription liability which they have incurred are subject, under Section 351 of the Internal Revenue Code, to taxation as ordinary income on the date of incorporation, leaving them, quite possibly, with no alternative except to sell the business. To remedy this problem, The Newsletter Association supports H.R. 2659, introduced by Rep. Rinaldo, which would amend the Internal Revenue Code to end the inequity created for unincorporated newsletter publishers by enactment of TEFRA. We suggest that the text of H.R. 2659 could be added to Title VI of The Tax Law Simplification and Improvement Act of 1983 (H.R. 3475) as a technical amendment.

For the information of the Committee, also attached is a copy of a letter written to Rep. James Sensenbrenner by Mr. Jerry Huss, publisher of CPA Digest in Milwaukee, Wisconsin, which outlines in some detail, the potential economic effects of the TEFRA provisions on the operations of the "typical" smaller newsletter publishers.

CPA DIGEST,
Milwaukee, Wis., January 31, 1983.

Hon. F. JAMES SENSENBRENNER, Jr.
House of Representatives,
315 Cannon Building,
Washington, D.C.

DEAR MR. SENSENBRENNER: As we discussed yesterday after the Brookfield Town Hall meeting, I'm requesting your assistance to correct a serious inequity in the Tax Equity and Fiscal Responsibility Act (TEFRA). Without this correction, many small businesses that publish newsletters could be forced either to close their doors or to sell out to larger corporate publishers.

As you requested, I am restating the problems in writing to assist you in acting on this matter.

THE PROBLEM

Section 201(b)(1)(B) of TEFRA includes "circulation expense" as a tax preference. So far, I haven't been able to determine the reason for this. I do know, however, that this new provision does not apply to those publishers who were already incorporated at the time TEFRA became effective.

The result on unincorporated publishers could be catastrophic. Circulation expenses are an essential part of our business—the only means by which we can obtain additional subscribers. (This is an important distinction from many tax preferences that are merely "paper deductions," such as depletion and accelerated depreciation.) Typically, circulation expense is the largest expense for a newsletter publisher.

To illustate the problem, let's assume that an unincorporated newsletter publisher has the following income statement:

Sales	$400,000
Expenses:	
Circulation	150,000
Editorial	120,000
Administration	100,000
Total	370,000
Net income	30,000

If we further assume that the publisher is married, has two children and itemized deductions of $6,000, his tax situation will be as follows:

Old tax law (1982 and prior):	
Federal income tax	$3,000
Income after Federal tax	27,000
TEFRA (1983 and after):	
Federal income tax ($20,000 more than under old law)	[1] 23,000
Income after Federal tax	7,000

[1] Would be even more if taxpayer has tax preferences other than circulation expense or has certain types of itemized deductions.

Obviously, this publisher could no longer support his family on the income remaining after paying Federal income tax.

At first, it would appear that this publisher could solve his problem merely by incorporating, since TEFRA doesn't include circulation expense as a tax preference for corporations. However, publishers typically have a large "deferred subscription liability," that is, an obligation to provide all issues due for the remaining term of each subscription. Under Section 351 of the Internal Revenue Code, this entire liability would be taxed to the publisher as ordinary income on the date of incorporation. For even a small publisher, this additional tax liability could easily exceed $100,000.

Thus, under new TEFRA Section 201, many small publishers will be faced with only two possible alternatives: discontinue operations or sell out to a corporate publisher.

THE SOLUTION

Immediate elimination of the portion of TEFRA Section 201(b)(1)(B) that includes circulation expense is the only hope of survival for many small, unincorporated publishers. I stress the word immediate, because this unwieldly tax provision is effective right now. Every time that I send out direct mail advertising with a cost of $10,000 my Federal income tax liability increases by $2,000. And, if I discontinue this "circulation expense," my business will die through the normal attrition of subscribers.

As I mentioned yesterday, I have two concerns about obtaining remedial legislation. First, the whole tax preference area is very complex. Thus, many IRS personnel and legislators may not understand the devastating effect of Section 201(b)(1)(B) on small publishers. Secondly, I estimate that about 100 unincorporated businesses face this problem. This number may not be large enough to arouse sufficient political support (even though it is a matter of financial survival to most of these publishers).

Thanks for your sincere interest in correcting this inequity. I appreciate your taking time to talk to me yesterday.

Very truly,

JERRY S. HUSS, CPA,
Publisher.

STATEMENT OF JONATHAN G. BLATTMACHR, ON BEHALF OF TRUSTS AND ESTATES LAW SECTION OF THE NEW YORK STATE BAR ASSOCIATION

The Tax Law Simplification and Improvement Bill of 1983 (H.R. 3475) would, among other provisions, provide a permanent rule for reforming charitable "lead" and remainder trusts so that they could be conformed to the requirements of the Internal Revenue Code so that the transferor would be permitted the applicable income, estate of gift tax deduction for the interest committed to charity. The Trusts & Estates Law Section of the New York State Bar Association supports the substance of this measure and urges its prompt enactment.

Under the terms of the Bill, only trusts which provide for an annuity or unitrust payment could be reformed; except for certain instruments drafted before 1979, no reformation of tax purposes would be permitted where an income interest (rather than an annuity or unitrust interest) precedes the remainder. We appreciate that a rule providing for the reformation of a charitable lead or remainder trusts where the remainder is preceded by an income interest (as opposed to an annuity or unitrust interest) may result in the allowance of a charitable deduction for the interest committed to charity even where the icome interest is not reformed into any annuity or unitrust interest because of a failure of the return to be audited and the claimed charitable deduction challenged. Nonetheless, numerous instances continue to arise even in instruments drafted after 1978 where the will provides for an income interest (as opposed to an annuity or unitrust interest) preceding the remainder as a result of the draftsman's failure to note the changes made to the Internal Revenue Code relating to such trusts by the Tax Reform Act of 1969. We believe that it would be appropriate to permit charitable lead and remainder trusts to be reformed where there is an income interest (as opposed to an annuity or unitrust interest) if such a reformation proceeding is commenced within the time within which the applicable tax return (including any extensions granted) is filed. We believe that allowing reformations under such limited circumstances is appropriate.

Accordingly, we also support a modification to the provisions in the Tax Law Simplification and Improvement Bill of 1983 to allow a charitable deduction where a reformation proceeding is commenced prior to the time that the applicable tax return is filed where an income interest (rather than an annuity or unitrust interest) precedes the remainder.

NEW YORK STATE BAR ASSOCIATION,
Trusts and Estates Law Section, July 22, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee, Longworth House Office Building, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: The Tax Law Simplification and Improvement Bill of 1983 (H.R. 3475) would, among other provisions, provide a permanent rule for reforming charitable "lead" and remainder trusts so that they could be conformed to the requirements of the Internal Revenue Code so that the transferor would be permitted the applicable income, estate or gift tax deduction for the interest committed to charity. The Trusts & Estates Law Section of the New York State Bar Association supports the substance of this measure and urges its prompt enactment.

Under the terms of the bill, only trusts which provide for an annuity or unitrust payment could be reformed; except for certain instruments drafted before 1979, no reformation for tax purposes would be permitted where an income interest (rather than an annuity or unitrust interest) precedes the remainder. We appreciate that a rule providing for the reformation of a charitable lead or remainder trusts where the remainder is preceded by an income interest (as opposed to an annuity or unitrust interest) may result in the allowance of a charitable deduction for the interest committed to charity even where the income interest is not reformed into any annuity or unitrust interest because of a failure of the return to be audited and the claimed charitable deduction challenged. Nonetheless, numerous instances continue to arise even in instruments drafted after 1978 where the will provides for an income interest (as opposed to an annuity or unitrust interest) preceding the remainder as a result of the draftsman's failure to note the changes made to the Internal Revenue Code relating to such trusts by the tax Reform Act of 1969. We believe that it would be appropriate to permit charitable lead and remainder trusts to be reformed where there is an income interest (as opposed to an annuity or unitrust interest) if such a reformation proceeding is commenced within the time within which the applicable tax return (including any extensions granted) is filed. We believe that allowing reformations under such limited circumstances is appropriate. Accordingly, we also support a modification to the provisions in the Tax Law Simplification and Improvement Bill of 1983 to allow a charitable deduction where a reformation proceeding is commenced prior to the time that the applicable tax return is filed where an income interest (rather than an annuity or unitrust interest) precedes the remainder.

Respectfully submitted,

ROBERT J. HUGHES, Jr.,
Chairman,

NEW YORK STATE BAR ASSOCIATION, TAX SECTION,
July 28, 1983.

JOHN J. SALMON, Esq.
Chief Counsel, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DOMESTIC RELATIONS TAX REFORM ACT OF 1983, H.R. 3475

DEAR MR. SALMON: I write to set forth the New York State Bar Association Tax Section's views concerning the Domestic Relations Tax Reform Act of 1983 (Title II of the Tax Law Simplification and Improvement Act of 1983 H.R. 3475) (the "Bill") introduced by Congressman Rostenkowski on June 30, 1983. A more complete analysis of the views of the Tax Section concerning the Federal tax consequences of divorce and separation is set forth in the Report of the Personal Income Committee of the Tax Section dated May 12, 1983 (the "Report") furnished to Congressman Rostenkowski with my May 20, 1983 letter.

The Tax Section urges the Committee to reconsider its approach to alimony and child support. In short, as practicing lawyers, we recognize that there is little or no distinction between alimony and child support or between property settlements and maintenance payments. These terms do not describe how the parties have agreed to divide their assets and future income potential. Rather, each term is little more than a tax rubric determining whether a payment will be includible/deductible or excludible/nondeductible. The bill, unfortunately, extends the concept that every payment may properly be characterized as either alimony, child support or property settlement, requiring well-advised taxpayers to mold their settlements into the desired statutory niche—a transactional form of election. To avoid the uncertainty, complexity and frequent injustice this process will engender, we urge the Committee to provide for simple, explicit "check the box" elections to treat all payments as either includible/deductible or excludible/nondeductible.

1. Bill section 202—Repeal of the Davis rule

The Tax Section supports repeal of the *United States* v. *Davis* rule, which requires a transferor spouse to recognize gain on the transfer of appreciated propoerty to his spouse in connection with a separation or divorce. Proposed new section 1041 of the Internal Revenue Code (the "Code") would extend nonrecognition (and carryover basis) treatment to all transfers, between spouses and former spouses where the transfer is incident to a divorce. Given the unlimited marital gift tax deduction provided for interspousal transfers (Code § 2523), the proposed amendment appears appropriate. We assume the drafters intend to thwart the potential abuse that might be present in interspousal tranfers when gain would be recognized and a new stepped-up basis established—eligible for ACRS deductions. The technical explanation of this provision should include an analysis of the tax treatment of interspousal transfers other than incident to a divorce.[1]

2. Bill section 203—Treatment of alimony and separate maintenance payments

The Report sets forth our view that the alimony and support payment rules should be modified to permit spouses to tailor the tax consequences of their matrimonial arrangements with a fair measure of certainty. The bill attempts to achieve this result by redefining "alimony or separate maintenance payments" in a simplified form and providing that those payments will be includible/deductible unless otherwise designated by the parties; payments that constitute property settlements or "child support" would continue to be excludible/nondeductible in all circumstances.

---

[1] Other Code sections, e.g., Code §§ 453(e)(1) and (f)(1), may have to be reviewed to determine if they should be amended if this approach is adopted. Presumably, the same concerns that prompt (or do not require) amendment to Code § 1239 would apply elsewhere.

We disagree with the bill's approach because we believe there is no practical, theoretical or historical basis for distinguishing between "alimony" and "child support." As discussed in the Report, the difference in the tax treatment of alimony and child support arose by "historical accident" resulting from a legislative concern for alimony payers in a period of rising tax rates.[2] That historical accident should not prevent individuals from freely determining the tax consequences of their marital settlements (as includible/deductible or excludible/nondeductible) in a straightforward, direct manner. By contrast, a statutory approach that permits individuals to achieve these results only by arranging the form of their marital settlements in accordance with elaborate statutory definitions, merely adds a layer of complexity and an additional opportunity for error that advances no discernable tax policy or legislative purpose.

In addition, we direct your attention to certain technical problems we perceive in bill section 203:

(a) Section 71(b)(1)(C), as amended, provides that the term "alimony or separate maintenance payment" will not include any payment made "for a transfer of property by the payee spouse." Freguently, property divisions will result in one spouse taking cash, the other, real or personal property. Often the parties do not have sufficent cash or other property to effect an equitable division. Recognizing this, they bargain for a package consisting of both property and future cash payments. To require them (and the Internal Revenue Service) to establish which portion of the future payments is attributable to "alimony" and which portion to "deemed asset purchases" ("netting"), invites uncertainty, confusion and litigation. The Report states our view that a "netting" approach will add to the difficulty of arranging marital settlements without eliminating any significant potential revenue loss, particularly since proposed new section 1041 will provide a carryover basis on the related interspousal property transfers.

(B) Proposed section 71(b)(1)(E) limits deductible "alimony or separate maintenance" payments to payments made where there is no continuing liability to make the payment after the death of the payee spouse and there is no liability to make any "payment (in cash or property) as a substitute for such payments after the death of a payee spouse." This provision may also foster litigation on the question of what constitutes a substitute payment.

(c) Proposed section 71(c) preserves the rule set forth in *Commissioner* v. *Lester*. In practice, parties to a divorce or marital separation frequently do not distinguish between "alimony and child support." These rubrics are, in large measure, used solely to distinguish between includible/deductible and excludible/nondeductible payments. Careful drafting, enables the parties to a marital settlement to achieve their substantive and tax goals. The less well advised will blunder either into or out of the desired treatment. We urge that tax certain results be made available to everyone by straightforward "check the box" includible/deductible or excludible/nondeductible elections, rather than by elborate clauses forcing payments into the desired "alimony" or "child support" categories. Well-counseled clients can and will effectively elect "deductible child support" or "excludible alimony." No discernable policy should prohibit this process. Certainly, none justifies making the election difficult or uncertain.

3. Bill section 204—Dependency exemptions for children of divorced parents

According to the technical explanation, bill section 204 is intended to eliminate the substantial number of disputes that have arisen between separated or divorced parents concerning who may claim dependency exemptions for their children. The bill attempts to resolve this problem by limiting the dependency exemption to the "custodial" parent, except in those cases where there is a specific written relinquishment of the right to claim the exemption.

We support the effort to eliminate matrimonial disputes over dependency exemptions for children of separated or divorced parents. The Bill's approach is inconsistent with our goal to provide maximum certainty and flexibility to individuals in negotiating matrimonial settlements. For these reasons we believe divorced or separated parents should be free to allocate dependency exemptions (but not partial exemptions) between them as they may agree in writing or by judicial decree.

We note that in an era when joint and other split custody arrangements are being utilized with increasing frequency a statutory approach based upon "custody" of children will become increasingly difficult to define and apply.

When the parties or the courts fail to allocate the dependency exemptions, a fallback position must be introduced. Here, we would—again for reasons of certainty and simplicity--provide that the custodial parent alone would be entitled to the dependency exemption.

---

[2] See the Report at pages 16–17.

4. Bill section 206—Estate and gift tax amendments

We support the proposed amendment to Code § 2043(b) that is included in Bill Section 206, which provides an estate tax deduction for transfers of property in exchange for marital rights. We would go further. Specifically, we urge that Code § 2516 also be amended to provide that divorce-related transfers of property made more than two years after the divorce also be free of gift tax. The law should not penalize spouses who fail to complete property transfers within a particular time frame.

The Tax Section applauds your efforts to improve this vital area of our tax law. We would be pleased to work with the Committee staff and others to provide whatever help and assistance you need to complete this task. We ask that you work with us and other segments of the organized bar to make this needed reform the best it can be, achieving certainty, simplicity, and fairness.

Very truly yours,

WILLARD B. TAYLOR, *Chairman.*

ONE TAX ALLIANCE
Arlington, Va., July 15, 1983.

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. SALMON: As requested by your office to-day, written statement herewith for members of the Committee, the printed record, the press and public.

In the summer of 1980, the Committee on Ways and Means held extensive hearings about tax cuts. (Serial 96-134.)

Many of the present committee's members heard that testimony.

Tax cuts, tax increases and adjustments have multiplied in the ensuing period, with disastrous results.

The One Tax Alliance presented a tax reform program, which went unheeded.

Now we are faced with mounting deficits as well as utter chaos.

The Committee invited proposals for revenue increases. Various proposals were listed as under consideration.

These would add to an already overburdened tax code, further confusing the public.

A ready revenue is immediately available through the suspension of all deductions, exemptions and credits in their accepted sense; substituting for each ⅔ value in the first year, ⅓ value in the second year and zero value in the third year.

Proper presentation by leadership will influence the people to accept their share of erasing our astronomical deficits, they having been on the receiving end of largess dispensed over the years.

Taxes are the price we pay for civilization. Responsible citizens feel their obligation, provided the achievement of social and economic ends is best left to a free and unfettered economy.

Relative to HR 3475 made part of this presentation, my publication "Taxes, Government provides the answer to simplification. Each year beginning with the Tax Reform Act of 1976, followed by a report of the staff of the Joint Committee on Taxation and practically yearly legislation dealing with simplification has been enacted. What in needed is simplification of the legislative process. Congress created it. Congress can simplify it. All it needs is the will. The people will back them.

SAMUEL GREENBERG, *Chairman.*

STATEMENT OF HON. LEON E. PANETTA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. Chairman, thank you for this opportunity to testify today on H.R. 3475, the Tax Law Simplification and Improvement Act of 1983. The bill, introduced by you and the ranking minority member, Mr. Conable, contains a number of important provisions, but in my remarks today, I will focus on Title VIII, which is modeled after my own legislation, H.R. 1540.

Title VII would eliminate needless restrictions against representation of taxpayers by certified public accountants and enrolled tax agents in cases where a relatively small amount of money is at issue. In these cases, an informal procedure is used, and this proposal would permit a taxpayer to engage the CPA or enrolled agent who prepared his return to explain its preparation and represent the taxpayer before the Court.

There are two sections of the Internal Revenue Code relevant to this issue—sections 7452, relating to representation of parties before the Tax Court, and 7463, relating to disputes involving $5,000 or less.

Section 7452 prevents the denial of admission to practice before the Court to any individual on account of his "failure to be a member of any profession or calling." However, it does not prevent the Court from establishing rules making it more difficult for members of a particular profession to qualify.

Section 7563 establishes a less formal procedure for the handling of cases involving sums of $5,000 or less. In other cases, formal procedures "in accordance with the rules of evidence applicable in trials without a jury in the U.S. District Court of the District of Columbia" are required. But Section 7563 allows flexibility in small cases so that they can be conducted in a manner that protects the taxpayer's rights but also allows a more rapid, nonappealable settlement of the case. In these cases, the standard rules of evidence are not enforced. This section is invoked at the taxpayer's option; it is not mandatory.

Under the current rules that have been established by the Tax Court no distinction is made between qualifying for representation in small cases and qualifying for representation in other cases. Attorneys qualify for practice before the Tax Court by filing an application that is accompanied by a certificate from the Clerk of the U.S. Supreme Court or from the high court of any State or territory or the District of Columbia showing that he or she is a member in good standing of the bar of that court. Any individual who is not an attorney and wishes to practice before the Tax Court must file an application, be sponsored by at least three persons already admitted to practice before the Court, and, most importantly, pass a written examination given by the Court.

To give the Committee an idea of the difficulty of this examination as it has been administered by the Tax Court, in the 5 years beginning in 1978 and ending in 1982 a total of 18 out of 240 professionals to whom the test was given, or about 7.5 percent, passed. A primary purpose of this test is to determine the individual's knowledge of courtroom procedure, rules of evidence, and the like. However, when cases are tried under Section 7563 for cases involving $5,000 or less, these guidelines are not even used. The whole point of Section 7563 is to provide a less formal setting to ensure a fair and rapid resolution of the case. An individual representating a taxpayer in such cases does not need to know a great deal about the rules of evidence since they are not in effect.

Of course, it is important that those representing taxpayers before the Tax Court know tax law. However, there is at least as much reason to assume that an accountant or other individual enrolled to practice before the Internal Revenue Service, who has had to pass state qualification standards in order to practice his profession, knows tax law as there is to assume that an attorney who may or may not have kept up with or even have any experience in tax law.

Most taxpayers who obtain outside assistance in the preparation of their returns employ certified public accountants or enrolled agents authorized to practice before the IRS. But if they get involved in a dispute with the IRS, they must hire an attorney if they wish to take their case before the Tax Court or find one of the relatively few accountants or enrolled agents who have qualified to practice before the Court. In small cases, it is very costly for the taxpayer to hire an attorney who is completely unfamiliar with the case. The taxpayer must pay for the time it takes the attorney to familiarize himself with the case as well as for the normal time it would take to prepare the case and argue it. He cannot make use of the certified public accountants or enrolled agent who knows how the return was prepared and has the knowledge of the tax rules required in the first place to do his job and to defend the return's preparation before the Court.

Enabling the taxpayer to make use of the individual who helped prepare his return would greatly expedite many cases before the Tax Court, and the fact is that time is an increasing problem for the Court, as backups have become severe, and the Chief Counsel of the IRS has stated that "we have to develop procedures for more efficient handling of cases." The fact is that cases adjudicated under section 7463 make up more than one-third of the Tax Court's caseload. Speeding these cases would help to bring about the increased efficiency which is so obviously needed.

As you know, Mr. Chairman, an important element of Title VII of H.R. 3475 was not included in H.R. 1540. This provision would permit the Tax Court to eliminate the test that it gives to non-attorneys to qualify for practice before the Court. Thus, the effective outcome of enactment of Title VII would be that accountants and enrolled agents, other than those who have already qualified to practice before the Court, would not be able to qualify for practice in large cases in the future, but they would face only the minimal requirements faced by attorneys for practice in cases involving less than $5,000.

The reason this provision was not in my bill is that I do not think it makes sense. If accountants or enrolled agents are able to pass the extremely difficult test given by the Tax Court, they should be able to practice before the Court in all cases. However, it is clear that the provisions of H.R. 1540 would not have been included in H.R. 3475 without some means of compromise, and I believe the compromise is well worth the achievement of this gain for small taxpayers.

Mr. Chairman, I strongly endorse Title VII of H.R. 3475. I want to thank you and Mr. Conable for including Title VII in the bill, and I hope the Committee will act swiftly to report this measure to the floor of the House. Thank you for this opportunity to testify.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., August 5, 1983.

Hon. DAN ROSTENKOWSKI,
Chairman, House Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR DAN: You will please allow me to bring to your kind attention section 501(b)(2)(B) of the Tax Law Simplification and Improvement Act of 1983, H.R. 3475, on which hearings have recently been held, and which is expected to be marked-up by your committee sometime in the fall.

Under this provision, certain aliens are exempted from U.S. tax liability on income earned in their home countries, as long as they spend less than 183 days in the United States in any one year and meet certain conditions ("substantial presence test"). One of these conditions is that these aliens may have a "tax home" in their countries of residence, but in referring to this exemption, the bill refers directly to section 911(d)(3) of the code as a definition. While the first sentence of that paragraph is on target with respect to the intent of the bill, the second sentence immediately following precludes any person owning a condominium, apartment or other home in the United States from claiming a tax home elsewhere.

My home area of Miami, Florida would be directly affected if the effect of this provision would be to preclude an alien residing in the United States less than 6 months a year from taking advantage of the "tax home" exemption under which he or she may pay taxes abroad on income earned abroad, as long as such a person owned a place in this country. We have many people, in my area, who like to own a condominium or apartment in Miami, for the purpose of a visit, even for a whole season, while their income and primary residence, or family home is their own country. It is understood that any income normally earned in the United States, even the appreciation of such a home here, is normally taxed here, but these people should not be allowed to be intimidated from owning a condominium in this country by having to pay taxes on income earned abroad in both nations, merely because they own, not rent, a place for them to stay for less than 6 months each year.

I ask you, if there is no substantial harm to the Treasury otherwise, or to the intent of the legislation, to make this small change in the reference to section 911(d)(3) by limiting it as a definition to the first sentence only. This way, the possible legal and marketing difficulties in the sale of apartments or condos in Miami could effortlessly be minimized, and I would appreciate it very much.

You would favor me, Dan, if you could make this request part of the record relating to this legislation, and I look forward to hearing from you, as to what may be done to clarify this language in the bill, so that no legitimate purpose may be lost to our economy.

Kindest personal regards, and
Believe me,
Always sincerely,

CLAUDE PEPPER,
Member of Congress.

Price Waterhouse,
Washington, D.C., July 29, 1983.

Mr. John Salmon,
Chief Counsel, House Ways and Means Committee, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

Statement Submitted by Price Waterhouse in Response to Request for Public Comments on H.R. 3475, the Tax Law Simplification and Improvement Act of 1983

Dear Mr. Salmon: The following comments are presented on H.R. 3475, the Tax Law Simplification and Improvement Act of 1983.

Title I

Though we concur with the Committee's overall efforts to simplify the Code with respect to individual estimated payments, we believe the exception based upon the prior year's facts and the current year's rates should be retained. This exception, primarily used when rates are reduced, provides taxpayers a simple procedure to avoid overpaying their estimated taxes while avoiding underpayment penalties. The complexity and uncertainty of relying upon estimates of the current year liability is avoided under this method. In the interests of providing taxpayers equitable treatment, we believe this exception should be retained.

Title II

Title II goes far in bringing equity to United States taxpayers wherever domiciled, and reduces the complexity of a number of provisions of the Internal Revenue Code. We believe, in addition, that it would be highly desirable to enact a change to Subtitle B providing that transfers incident to divorce are not taxable gifts and also qualify as a deduction for estate tax purposes. Thus the holding in *Harris* (340 U.S. 106) would be codified. These changes would confirm that transfers will not result in a federal income, estate, or gift tax simply because of division of the marital properties. Additionally, Code Section 2516 should be modified to reflect the elimination of gift and estate taxes on transfers between spouses.

Title III

We believe the provisions for financing qualified business property of S corporations should be extended to partnerships, specifically limited partnerships. In general application, there appears no justification for a difference in treatment between S corporations and partnerships.

Title V

Section 501(a) is attempting to establish, for the first time, a concrete set of criteria for the purpose of defining a resident and nonresident alien. We commend this attempt to inject assurance into an area hitherto fraught with uncertainty. On the other hand, we object to criteria that impose so rigid an approach as to fail to accomplish the intended goal. Our comments with regard to proposed new Section 7701(b) are offered from this point of view.

(1) *Proposed section 7701(b) (1) and (2).*—We feel that the first two criteria provided in Section 7701(b)(1)(A) ("green card" test and "green card application" test) to define resident alien are reasonable, particularly because they are intended to be reflective of factual situations. The third criterion (i.e., the substantial presence test), however, is arbitrary, involving a mere counting of days of U.S. physical presence without regard to any qualitative factors, and, based on our vast experience advising aliens on U.S. tax matters, will give rise to anomalous results. We would suggest consideration be given to the following changes in the present proposal:

(A) The 183-day substantial presence test should be made with respect to the current year only, eliminating the look backward to the two previous years. In other words, an alien physically present in the U.S. for 183 days or more in any year will be a resident, subject to the exception of paragraph (b)(2)(B). Not only will such a rule be simpler to apply, but it would eliminate the distortions that the look backward can create.

(B) The (b)(2)(B) exception should eliminate a numerical threshold and should be applied to aliens having a tax home abroad and having closer economic ties to the country in which that tax home is located than to the U.S. Such a broadened exception would ensure that aliens who are clearly nonresidents, as reflected in the facts and circumstances, will not be arbitraritly ensnared into a residency situation.

(2) *Proposed section 7701(b)(1).*—The proposed rules seem to make an alien a U.S. resident for the entire year if he qualifies as a resident under either of the first two criteria ("green card" test or "green card application" test) at any time during that year. We would suggest that the alien be treated as resident as from the day he enters the U.S. or obtains his green card, whichever is earlier, in the case of the "green card" test and as from the day the visa application was submitted or, if later, the day the 60-day presence period commenced, in the case of the "green card application" test. We think that this treatment is more equitable than that contained in the statutory language.

(3) *Proposed section 7701(b)(2).*—We strongly recommend that the substantial presence test, if adopted as contained in the proposed legislation, as suggested by us herein, or in any other form in which it relies essentially on an arbitrary counting of days rather than by reference to facts and circumstances, *not* be applied to treat an alien as a resident for purposes of Sections 531, 541, 551, 679 and 957.

(4) *Proposed section 7701(b)(3)(F)(i).*—We agree that special rules are necessary for special situations, including teachers and trainees. We do think, however, that the limitation of this subparagraph (F)(i) is too restrictive. Literally interpreted, an alien who had completed a college or garduate level course of study at a U.S. university would become a resident alien if he or she should wish to remain here temporarily as a business trainee or teacher, despite the fact that the individual's intentions are to return to his or her home country. We believe that either a prior qualification 251 full-time student should not disqualify an alien from the teacher/trainee exemption (i.e., eliminate "or (iii)" in the statutory language) of the facts and circumstances of the immediately succeeding subparagraph (F)(ii) be incorporated into subparagraph (F)(i).

(5) *Proposed section 7701(b)(8)(A).*—Although we understand the aim of the proposed rule is to prohibit aliens who become new U.S. taxpayers from electing fiscal year U.S. tax reporting, we believe the new rule is too broad. There are a number of countries which do not use the calendar year for local tax reporting (e.g., U.K., Australia, Hong Kong, etc.). We suggest that aliens residing in these countries, even if they should become temporary residents of the U.S. under the new rules, should be permitted, as a convenience, to report for U.S. tax purposes on the same fiscal year as in their home countries, if they so desire. Thus, the use of a tax year other than a calendar year would be reasonably well controlled while still accomplishing the intention of the legislation.

(6) *Proposed section 7701(b)(8)(B).*—To the extent that aliens will be allowed to continue using noncalendar tax years, we believe it would be both simpler and more equitable for such aliens to satisfy the resident or nonresident tests by reference to their fiscal years, rather than the requirement contained in this subparagraph focusing on the calendar year irrespective of the actual fiscal year.

Section 502 of the bill would amend Section 879 by broadening the application of the mandatory rules of attribution between spouses of community income to two nonresident alien spouses in addition to, as in the case under the existing statute, a married couple with only one nonresident alien spouse. The thrust of the amendment is to preclude the use of applicable community property rules to U.S. source earned income. For the reason specified below, we believe that the change unfairly discriminates against nonresident aliens. In the case of two nonresident aliens. The U.S. source earned income will not escape U.S. taxation even if treated in accordance with the community property regime—if will merely be split between two taxpayers. This is an option available to two U.S. citizen or resident spouses of domiciled in a community property state and should likewise be available to nonresident alien spouses domiciled in a community property jurisdiction. We suggest that this proposal be withdrawn.

Section 503 of the bill would provide certain technical amendments to the indirect and constructive ownership rules contained in the foreign personal holding company (FPHCo) provisions. We note, however, that the change suggested in the FPHCo family attribution rules (i.e., excepting from attribution to citizens or residents stock owned by nonresident aliens) falls short of the comparable provision of Section 958, relating to controlled foreign corporations. The Subpart F rule precludes, in general, under the family rules, attribution of stock owned by a nonresident alien to a U.S. citizen or resident. The proposed rule of FPHCo attribution is similar except that it would continue to permit attribution from a nonresident alien spouse. We suggest that the proposed change be altered to conform to the applicable CFC rule, in the interest or greater harmony between the two sets of conceptually similar provisions.

Section 505 of the bill would change this longstanding, and sometimes ambiguous, provision in the law providing for better coordination between the FPHCo and CFC provisions. We concur that better coordination between these provisions is desirable, particularly because they are conceptually similar and have similar, although not identical, purposes. In the interest of simplification, thought should be given to outright repeal of the FPHCo provisions on the theory that the CFC provisions would carry out reasonably well, albeit perhaps with some minor changes, the original intention of the FPHCo provisions. We believe that this suggestion is worthy of serious consideration and would be willing to assist with a feasibility study to explore the effects thereof.

Section 506 of the bill would add Section 269B to the Code, dealing with stapled entities. In our opinion, this proposed section should be withdrawn for further study and consideration. The skeletal manner in which it is written leaves too many serious questions unanswered and therefore leaves much too much statutory content to the already overburdened regulation drafting process.

New Section 269B(a)(1) and (2) would treat a stapled foreign entity as a domestic entity, and further will treat it as a subsidiary of the domestic corporation to which it is stapled. Some of the questions that arise in this situation are:

Will the foreign entity be currently subject to U.S. tax, bearing in mind the fact that if it were a foreign subsidiary of the domestic entity, its income would not be taxable in the U.S., absent Subpart F or FPHCo applications, until remitted?

Will it be eligible to join in the filing of a consolidated return?

Will its dividends give rise to the dividend received deduction?

Will Section 367 apply when the stapled foreign entity is transformed from foreign to domestic at the effective date of the proposed legislation?

Will the foreign entity be entitled to all the deductions and credits that apply to a domestic corporation?

How will the "foreign/domestic" entity be regarded under U.S. tax treaties?

How is the provision intended to apply if the stapled situation is the creation of a foreign group? For example, if a U.K. parent creates a stapled U.S. corporation to carry out its U.S. (or non-U.K. business), a literal reading of the statutory language would treat the U.K. group parent as a U.S. company (and perhaps as a subsidiary of the U.S. entity).

These questions make it clear that the legislation as drafted has not been carefully thought through, and leaves too much legislative discretion to the IRS. Since, in our experience, the degree of use of stapled entities is quite small, we would suggest removing this provision from the bill for the purpose of giving it more thorough study and review.

We will be pleased to discuss any of the above comments at greater length.

Yours very truly,

R. P. KELLY.

PRICE WATERHOUSE,
New York, N.Y., August 12, 1983.

Mr. JOHN SALMON,
Chief Counsel, Ways and Means Committee, U.S. House of Representatives, Longworth House Office Building, Washington, D.C.

SUPPLEMENTRARY STATEMENT SUBMITTED BY PRICE WATERHOUSE IN RESPONSE TO REQUEST FOR PUBLIC COMMENTS ON H.R. 3475, THE TAX LAW SIMPLIFICATION AND IMPROVEMENT ACT OF 1983

DEAR MR. SALMON: In addition to those comments included in our letter of July 29, 1983 we offer the following additional observations.

TITLE V

(1) *Proposed section 7701(b)(1).*—In our previous letter we pointed out that the proposed rule seems to make an alien a U.S. resident for the entire year if he qualifies as a resident under either the "green card" test or "green card application" test. We suggested that the alien be treated as a resident as from the day he enters the U.S. or obtains his green card, whichever is earlier; or, in the case of the "green card application" test, from the day the visa application was submitted or if later, the day the 60-day presence commenced.

We would like to add that the same part year resident concept should apply in the year in which a resident alien gives up his U.S. residency. This could be accomplished by treating an alien as a nonresident from the first day on which the former resident is outside of the United States after having informed the Internal Revenue Service and the Immigration Service of his termination of residency and relinquishment of his green card.

(2) *Proposed section 7701(b)(2).*—In our previous letter we recommended that any mechanical test of residency which relies upon the counting of days not be applied to treat an alien as a resident for purposes of Sections 531, 541, 551, 679, and 957. We would like to add to this list Sections 367, 1491, and 1361 and Subtitle B of the Internal Revenue Code relating to estate and gift taxes.

(3) *Proposed section 554.*—The proposed addition to Section 554 contains the phrase ". . . stock owned by a nonresident alien individual (other than a foreign trust or foreign estate). . ." the parenthetical portion of this phrase seems to modify the term "individual". Since the term "individual" does not generally include trusts and estates, this particular phrase is confusing. We recommend deletion of the parenthetical phrase.

Please contact us if you wish to discuss any of the above comments.

Yours very truly,

RICHARD M. HAMMER.

THE SANTA ANITA COMPANIES,
Los Angeles, Calif., July 26, 1983.

Re: H.R. 3475, Section 506, Stapled Stock.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This statement is submitted on behalf of Santa Anita Realty Enterprises, Inc., and Santa Anita Operating Company, Delaware corporations, in response to your announcement of a public hearing on H.R. 3475, the "Tax Simplification and Improvement Act of 1983." Because of the short notice and the complexity of the tax consequences of this legislation, we did not request an opportunity to present oral testimony at the hearing on July 25, but do request that this statement be made a part of the printed record of the hearing.

SUMMARY OF CONCERN AND POSITION

Section 506 of H.R. 3475 contains provisions which would treat as one entity, commencing January 1, 1985, domestic entities whose stock was "stapled" on June 30, 1983, for the purpose of determining whether one of the entities qualifies as a real estate investment trust (REIT) under section 856, et seq., of the Internal Revenue Code of 1984 (Code). Santa Anita Realty Enterprises, Inc. (Realty) is a domestic corporation qualifying as a REIT whose stock is stapled, within the meaning of that term as defined in section 506 of the bill, with the stock of Santa Anita Operating Company (Operating Company), also a domestic corporation conducting its own business. We are concerned about the effect of this proposed legislation on the operations of these two companies and their shareholders.

The application of this legislation to REITs would require either termination of REIT status or a severing of the stapled relationship. For this reason, and because stapled stock involving REITs has been specifically approved by ruling of the Internal Revenue Service in the case of Realty as well as a number of other REITs, we believe that the only equitable approach to such a fundamental legislative change, if it is necessary, would be to exclude permanently all existing stapled situations involving REITs.

BACKGROUND

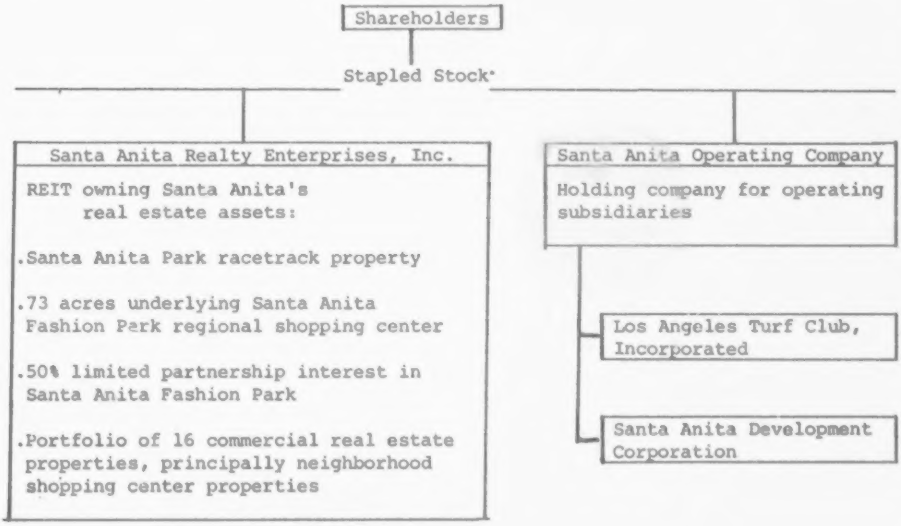
Realty and Operating Company are the successors of Santa Anita Consolidated, Inc. and predecessor companies (Santa Anita). Santa Anita was founded in 1934 by Dr. Charles H. Strub and a group of investors to own and operate the Santa Anita Racetrack in Aracadia, California. Santa Anita Racetrack is now one of the largest and most prestigious thoroughbred racetracks in the world and has earned a respected place as a quality entertainment center in Southern California.

Over the years, the original racetrack operation has grown to include other operations—particularly in real estate—and the original company has grown from a small privately-owned corporation to a medium-size company with approximately 2,400 employees during racetrack operations and over 7,000 shareholders. The stapled shares of the Santa Anita Companies are now traded on the New York Stock

Exchange as Santa Anita Realty Enterprises—symbol SAR. (For additional financial data regarding The Santa Anita Companies, see attached annual reports for 1981 and 1982.)

In 19~~79, San~~ta Anita considered the possibility of reorganizing its real estate ownership in the form of a qualified real estate investment trust. The objective of such a reorganization was to accomplish two purposes: (1) take advantage of REIT tax treatment for the Company's growing real estate investment business; and (2) to clarify the image of the Company in financial markets so that these markets would better understand the Company's participation in the ownership of major real estate assets.

Preliminary discussions with the Internal Revenue Service [IRS] in early 1979 indicated that the IRS was favorably disposed toward a reorganization which contemplated dividing Santa Anita into two companies—one a REIT and the other an operating company on a stapled stock basis. The principal reason for proposing the stapled stock form of reorganization was to mitigate possible conflicts of interest and at the same time preserve ownership continuity in the best interest of Santa Anita's shareholders. On October 16, 1979, Realty obtained an IRS ruling approving its reorganization plan and specifically recognizing the stapled stock arrangement. Once the favorable ruling was received, all of the other steps necessary to accomplish the reorganization were finalized and the reorganization became effective on January 1, 1980 following an overwhelmingly favorable vote of shareholders. The cost of this reorganization in legal, accounting, and other advisory services and filings amounted to approximately $1 million. The Companies resulting from the reorganization may be depicted as follows:


Shareholders
Stapled Stock*
Santa Anita Realty Enterprises, Inc.
REIT owning Santa Anita's real estate assets:
.Santa Anita Park racetrack property
.73 acres underlying Santa Anita Fashion Park regional shopping center
.50% limited partnership interest in Santa Anita Fashion Park
.Portfolio of 16 commercial real estate properties, principally neighborhood shopping center properties
Santa Anita Operating Company
Holding company for operating subsidiaries
Los Angeles Turf Club, Incorporated
Santa Anita Development Corporation

Since the reorganization, Realty's property investments have been augmented by a joint venture in an 800,000 square-foot, 45-acre industrial park development, and currently Realty has plans to invest in additional shopping center properties, and possibly an apartment house development. Operating Company's operation of thoroughbred horse racing at Santa Anita Park has been growing in recent years and during the last two years, in terms of average daily attendance and handle, has ranked as number one in these categories in the United States. In addition Operating Company, through its subsidiary Santa Anita Development Corporation, owns or is in the process of developing shopping center properties with a book value in excess of $35 million. Today the combined companies have real estate assets held for investment valued by Landauer Associates at more than $151 million, and the market value of their shares is approximately $137 million.

CONDITIONS OF IRS RULING

The IRS ruling includes two important conditions. First, the reorganization involved spinning off to Santa Anita's then 4,125 shareholders the stock of Santa

Anita Operating Company. This distribution was required by the IRS to be taxable as ordinary income to Santa Anita's shareholders for federal tax purposes. The distribution was also taxable for state tax purposes.

Second, the IRS ruling of 1979 specifically prohibits Realty and Operating Company from having the same officers and employees. Implicit in this condition of the ruling is the requirement that all transactions between the companies be "arms length" with terms fair to each Company.

In the period following the reorganization, Realty and Operating Company have meticulously followed the conditions of the IRS ruling. The operating management of the two companies are separate and distinct. The two companies allocate costs on a strict arms length basis according to the service and value received by each company. Each transaction between the two companies is carefully scrutinized to make sure the "arms length" test is met.

RELIANCE IN IRS RULINGS

The IRS first ruled favorable on the formation of "stapled interests" by a REIT in 1971. See Letter Ruling 7102086720B (February 8, 1971). Under slightly different conditions the IRS issued a second ruling in 1976 approving the formation of stapled interests by another REIT. In each of these cases the stapled interest was held in trust for the benefit of REIT shareholders.

The stapled arrangement used by The Santa Anita Companies and other REITs, which also obtained subsequent favorable rulings, were effected through bylaw amendments and pairing agreements so that the shareholders owned both interests directly without intervention of a trust. See Letter Ruling 8002026 October 16, 1979, issued to Santa Anita. This ruling, and the rulings issued to other taxpayers, included the following conclusion by the IRS:

> In the instant case, (Operating Company) is a separate corporate entity that should be recognized under the principles of *Moline Properties* v. *Commissioner,* 319 U.S. 436 (1943). Although the shareholders of (Realty) will benefit from the concurrent ownership of shares of a real estate investment corporation (REIT) and (Operating Company), a business not subject to the REIT restrictions of the Code, this benefit cannot be held to be that of (Realty). Control of (Operating Company) is in the hands of the (Realty) shareholders who own the (Operation Company) stock and is not exercisable by (Realty). (Operating Company) is subject to tax, subject to risk of loss, can make profits other than through tax savings and has a business purpose.

From this statement, it can be assumed that the IRS did not make its determination in these cases lightly without consideration of the fundamental legal issue involved, i.e. whether the two entities were to be properly recognized as separate for tax purposes. On this question the IRS considered itself bound by substantial judical authority. The fairness of applying this proposed legislation to existing stapled REITs must be weighed carefully against the background of this IRS ruling authority on which taxpayers have relied in creating these long-term investment vehicles. In Santa Anita's case, the Companies would not have considered reorganizing without the backing of the favorable IRS ruling.

Given this reliance, the application of section 506 to pre-existing stapled interests would not be consistent with the standards of equity applicable over the years in connection with the retroactive application of changes in tax policy. We note, for example, that the Tax Equity and Fiscal Responsibility Act of 1982 adopted carefully crafted effective date limitations on the application of new restrictions on corporate mergers and acquisitions and excluded situations with respect to which the taxpayer had relied on a favorable IRS ruling.

Accordingly, we urge that if the enactment of section 506 is deemed necessary, existing stapled interests of REITs be excluded.

REASON FOR REIT LEGISLATION UNCLEAR

As described by Congressman Rostenkowski, the purpose of section 506 is to "deal with a long-standing problem regarding so-called stapled stock" involving U.S. corporations which have "attempted to avoid the subpart F rules and the anti-boycott rules by splitting off their foreign operations and conducting them through separate corporations." See Congressional Record June 30, 1983 page H4881. Under subpart F, certain earnings of a foreign subsidiary of a U.S. corporation are taxed to the parent corporation as if distributed as a dividend. If the stock of the foreign subsidiary is distributed to the parent corporation's public shareholders, the deemed distribution under subpart F may be avoided. This transformation occurs because the foreign subsidiary is no longer an affiliate of the parent but is, after the distribution of its shares, owned by public shareholders who are not subject to tax under subpart F. The effect of this arrangement is to assure deferred of U.S. tax until the foreign subsidiary earnings are actually distributed to shareholders.

By contrast, stapled interests of REITs do not involve tax avoidance by either stapled entitly. Income from the non-REIT activities of Operating Company are subject to tax to the same extent as they would be if the two entities were owned separately. Income of the REIT is qualified income for purposes of section 856. To the extent that any tax problems exist in such a situation, they relate to the fairness of the transactions between the two entities. Indeed, this was a factor addressed in the specific conditions of Realty's IRS ruling. New legislation is not needed to enable the IRS to control a possible abuse in this area. There are adequate restrictions under existing law to assure that amounts of income and deduction are fairly allocated between the two entities. The REIT tax provisions are adequate to assure that income allocated to the REIT is qualified income.

Restrictions on the use of stapled interests by REIT's do not belong in this proposed legislation. If a statutory amendment is deemed necessary, we believe that such legislation should be considered in the context of a comprehensive review of the REIT rules. Effective as of February 17, 1981, the IRS indicated that it would no longer issue rulings under section 856 on the formation of stapled interests involving REIT's where "the activities of the corporations are integrated." See Rev. Proc. 81-4, 1981-1 CB 619. The IRS has not elaborated further on the problem which it perceives to exist in this area. However, this "no ruling" policy should adequately protect the IRS from the effect of any structural problems which might exist under present law pending a study of the REIT provisions. Finally, it should be emphasized that section 506 as an amendment of section 269 of the Code, which deals with "Acquisition Made to Avoid or Evade Income Tax" is hardly an appropriate context for structural changes in the REIT tax regime.

We urge the Committee to reject the stapled stock restrictions for REITs as not germane to the policy problems involved in the subpart F area. Instead, we believe the tax considerations relating to REITs should be considered in the context of a review of the overall REIT tax regime. To the extent changes are deemed necessary, they should be made prospectively only, excluding existing stapled REITs.

Sincerely,

ROYCE B. MCKINLEY,
President, Santa Anita Realty Enterprises, Inc.

SCHWARTZ, DEVENPORT & SCHWENDIMANN,
July 28, 1983.

Re H.R. 3252 and Section 401 of the Tax Law Simplification and Improvement Bill of 1983 (H.R. 3475).

House of Representatives, Committee on Ways and Means, Longworth Building, Washington, D.C.

TO THE MEMBERS OF THE HOUSE COMMITTEE ON WAYS AND MEANS: This is a letter in support of the concepts of H.R. 3245 and Section 401 of the Tax Law Simplification and Improvement Bill of 1983. I request that this statement be included as part of the record of the hearing on these bills.

Section 401 of H.R. 3475 and H.R. 3252 would provide a permanent rule permitting qualified reformation of a charitable split-interest instrument which does not meet the statutory requirements of Section 2055(e)(2).

Section 2055(e)(2) was added by the Tax Reform Act of 1969 in order to correct perceived abuses in the valuation of charitable remainder interests under split interest trusts, to ensure a closer correlation between the amount of the estate tax charitable deduction and the present value of the amount ultimately passing to the charity. *Gillespie Estate* v. *Commissioner,* 75, T.C. 374 (1980). Section 2055(e)(2) disallows any deduction for a remainder interest under a split interest trust unless the trust is a charitable annuity trust or charitable remainder unitrust as defined by statute.

In order to mitigate the harsh consequences and strict technical requirements of section 2055(e)(2) numerous transitional rules were provided by the Congress and the Treasury Department to permit reformation of nonqualifying instruments. The history of those rules is well known and need not be set out here. The final date after which a reformation was no longer effective was December 31, 1981.

While the focus of the Congress in enacting Section 2055(e)(2) was to ensure a closer correlation between the amount of the estate tax charitable deduction and the amount ultimately passing to the charity, the focus of the Internal Revenue Service in administering that Section has been on the technical perfection of the governing instrument.

While the "boiler plate" provisions of a qualified split-interest trust are provided by Rev. Rul. 72-395, 1972-2 C.B. 340; Rev. Rul. 82-128, I.R.B. 1982-27, 7; and Rev. Rul. 82-165, I.R.B. 1982-40, 8, even the most meticulous tax practitioner can not be absolutely sure that the Service will not deny the qualification of the split-interest trust based on other grounds.

Take for example the Service's position as set forth in Ltr. Ruls. 7942073 and 7732011. The decedents' wills reviewed by the service each established a charitable remainder unitrust. The documents were submitted to the Service for rulings on valuation of the charitable remainder interest. Each will, however, contained an "in terrorem" clause that provided that any will or trust beneficiary who contested the validity of the will would lose his rights to any bequest. The Service ruled that this provision disqualified the trust; since, if a beneficiary were to contest the will, the unitrust payments would terminate before the life of the beneficiary or before the expiration of the term specified under § 2055. Accordingly, no estate tax deduction was permitted.

The Service has also used the provisions of Section 2055(e)(2) to deny a charitable deduction upon the acceleration of a charitable remainder resulting from a will contest settlement. See, Rev. Rul. 77-491, 1977-2 C.B. 332. While arguably a justifiable position based on a literal reading of the statute, the result has little to do with the Congressional intent of Section 2055 (e)(2) to ensure a close correlation between the amount of the estate tax charitable deduction and the value of the amount ultimately passing to the charity.

This inconsistency was recognized in *The Northern Trust Company* v. *U.S.*, 78-1 U.S.T.C. ¶ 13,229 (N.D. Ill. 1977), in which a Federal District Court allowed a charitable contribution for the amount actually received by the charity in accordance with a will contest settlement.

The *Northern Trust* case, however, stands alone for the proposition that substance should govern over form in the area of charitable deductions for remainder interests under split-interest trusts, and the Service maintains its position that no deductions are allowable for a remainder interest passing outright to a charity as a result of settlement of a will contest where the original bequest is not in the form of a charitable remainder annuity trust or unitrust or pooled income fund. The I.R.S. standard of determining whether the settlement is representative of the forms of benefits the charity could have received is elusive at best, and the result reached in *Northern Trust* obviates a need for second guessing of possible litigation outcomes. *Petkin, Hamlin & Downing,* 435 T.M. Charitable Remainder Trusts and Pooled Income Funds, page A-60.

The lengths to which tax practitioners have gone in their efforts to save a charitable deduction are clearly reflected in the recent case of *Edmisten* v. *Sands,* 300 S.E. 2nd 387 (N.C., 1983.) See also, In re Estate of *Burton-Miller,* 456 A. 2nd 1266 (Ne., 1983). In *Edmisten* the decedent by will created a charitable remainder unitrust. The trust was defective, however, because of the failure of the will contain some of the technical provisions required by the I.R.S.

The Attorney General of the state of North Carolina, acting in the public interest, initiated an action seeking a judgment construing the will to provide that the trust must be administered in accordance with the requirements of the I.R.S. regulations pertaining to charitable remainder unitrusts.

The Supreme Court of North Carolina, based upon a specific North Carolina statue which allows a Superior Court to order administration of charitable trusts in a manner that as nearly as possible fulfilled the manifested general charitable intent of the testator, held that the will must be construed so as to require the trust be administered in full compliance with the applicable I.R.S. regulations.

The lower court had entered an order construing and reforming the will to require administration in accordance with the I.R.S. requirements. The Supreme Court of North Carolina held reformation of the will was improper and the will must be "construed" to require administration in compliance with the I.R.S. regulations. In doing so the Court stated:

> We reject reformation as an appropriate remedy in this case because the Internal Revenue Service takes the position that a governing instrument speaks as of the date it becomes effective, in this case the date of death of [the testator]. Under this view, the tax consequences would become fixed at that time. Arguably, an order reforming the trust would only speak from the date of the entry of the order and

would not assure the favorable tax treatment with respect to a charitable deduction. Conversely, an order constructing the will to require from its creation administration in compliance with the regulations would assure that the estate would be entitled to the charitable deduction. *Edmisten* supra, at 392.

It is my understanding from discussing the *Edmisten* case with attorneys involved that the Internal Revenue Service has not accepted the "construction" of the trust instrument by the Court and has denied the charitable deduction.

A common tool of the tax practitioner to cure defects in charitable remainder trusts in the past has been the use of a disclaimer. See, e.g. *Estate of Jaecker* v. *Commissioner,* 58 T.C. 166 (1972). In that case the Tax Court held that the income beneficiary's disclaimer of the trustee's disqualifying administrative powers saved the charitable deduction with regard to a pre-1969 charitable remainder trust.

Under Section 2518 of the Internal Revenue Code, for the purposes of the estate and gift tax, if a person makes a qualified disclaimer with respect to any interest in property, the estate and gift tax laws shall apply with respect to such interest as if the interest had never been transferred to such person.

Arguably, if a testamentary trust were not qualified because of some defect concerning the payment of the annuity or unitrust amount, the recipient's qualified disclaimer should preserve the deduction. *Petkin, Hamlin & Downing,* 435 T.M., supra, at Page A-65.

The confusion generated by the Service's proposed regulations under Section 2518, however, casts a serious doubt as to whether a qualified disclaimer may be used with respect to a charitable remainder trust.

Proposed Regulation Section 25.2518-3(a)(2) provides: Similarly since all interests in the corpus of a trust are treated as a single interest, in order to have a qualified disclaimer of an interest in corpus the disclaimant must disclaim all such interests, either totally or as an undivided portion. Thus if a disclaimant has a testamentary power of appointment over the trust corpus coupled with either an inter vivos power to invade corpus or an interest as a discretionary appointee of corpus, a disclaimer by that person can constitute a qualified disclaimer only if both such interests are disclaimed. Moreover, a disclaimer of both an income interest and a remainder interest in specific trust assets is not a qualified disclaimer if a beneficiary retains interest in other trust property. The disclaimer of either the entire interest in income, corpus or both or a disclaimer of an undivided portion of such interests may be a qualified disclaimer.

Proposed Regulation Section 2518-3 seems to say that in any transfer in trust only two property interests are created; an interest in the trust corpus and an interest in the trust income. In order to meet the definition of a "qualified disclaimer" the entire interest in income, the entire income in corpus, or both, or an undivided portion of such interest must be disclaimed.

Since in a split-interest trust the amount paid to the non-charitable beneficiary may by definition be made up of both corpus and income, the proposed regulations would seem to preclude any disclaimer used in connection with a charitable remainder trust from meeting the definition of a "qualified disclaimer", other than a disclaimer of the entire or an undivided portion of the unitrust amount. The result of the *Jaecker* case would not be possible under the proposed regulations.

From telephone conversations with various individuals in the Legislative and Regulations division of the I.R.S. and within the office of the Estate and Gift Tax Section Chief, it was clear to me that in drafting the proposed regulations, the impact on disclaimers of interest in charitable remainder trusts had not been considered.

Section 2055 clearly evidences Congressional intent to encourage charitable bequests. The provisions of the Tax Reform Act of 1969 which were made to correct abuses and ensure closer correlation between the amount of the estate tax charitable deduction and the value of the amount ultimately received by the charity was a necessary evolution in the estate tax law.

The passage of a permanent rule permitting reformation of charitable split-interest instruments which do not meet technical requirements of the 1969 act when there is an obvious intent to comply with the 1969 act would be a tremendous step forward.

Not all charitable remainder trusts are drafted by big law firms in New York, Washington and Los Angeles, or by attorneys who are experts in the field of tax law. The great majority of wills are drafted by general practitioners who are good lawyers, but who cannot be expected to meet the standard of absolute perfection now imposed by the IRS.

Our office is currently engaged in an attempt to ensure a deduction for a split-interest trust that may be subject to a challenge by the IRS for technical shortcomings.

There is no question that the intent of the decedent was to pass the majority of his estate to charity in the form of a qualified charitable remainder trust. Almost the entire estate was put into a charitable remainder unitrust.

The testator had a will that had been prepared by a prominent east-coast law firm. Prior to his death in 1982, the decedent had moved to Santa Fe, New Mexico. The decedent desired a few minor changes in his will and went to a local practitioner to have a new will made incorporating these changes.

As a result of the minor changes, a good portion of an approximately one million dollar bequest to a small college has been jeopardized.

The tremendous waste of resources of the government, charities and the non-charitable beneficiaries in attempts to obtain the benefits of a charitable deduction for a trust instrument which contains a technical defect is obvious from the number of cases, revenue rulings and private letter rulings that have been generated on the issue since the passage of the 1969 act. I cannot believe that anyone is satisfied with the situation as it presently exists.

With regard to the specific bills before the committee, the approach taken by H.R. 3252 is preferable. The goal of any remedial legislation should be to provide a straight-forward method of reformation. The provisions of Section 401 of H.R. 3475 impose significant preconditions and technical requirements before reformation is allowed. In my opinion the technical requirements of H.R. 3475 would cause further uncertainty in this area.

I urge the Committee to take this opportunity to clarify and simplify an area of the tax law that for years has resulted in conflict, litigation, and reduction in the amounts ultimately received by charity.

Respectfully submitted,

RANDALL J. MCDONALD.

STATEMENT OF ROBERT B. WHITE, CORAL GABLES, FLA.

Section 501 would amend Section 7701 of The Internal Revenue Code of 1954 (relating to definitions) by inserting tests and other criteria intended to simplify the definitions of a resident alien and a nonresident alien. My objection is particularly addressed to the "Substantial Presence Test" in Section 501(a), for the following reasons:

I. THE SUBSTANTIAL PRESENCE TEST IS AN UNNECESSARY SUBSTANTIVE CHANGE IN THE TAX LAWS

The stated objectives of H.R. 3475 are to simplify and improve the tax laws. It is submitted that adoption of the Substantial Presence Test would have the opposite effect. Currently, an alien who has not indicated any desire or intention to become a lawful resident of the United States is generally considered to be a nonresident if he is present in the United States on fewer than 183 days of a calendar year, regardless of the number of days he may have been present during preceding years. This is a simple test. It does not entail complicated record keeping. It is simple to enforce, and it is not apt to entrap a bona fide nonresident alien into unwitingly being declared a resident because of the duration of his sojourn in the United States one or two years earlier.

The Substantial Presence Test goes beyond codifying the existing law for determining whether an alien individual who is present in the United States fewer than 183 days a year is a resident or a nonresident of the United States. The Substantial Presence Test is a novel concept. It is not merely concerned with the number of days an alien individual is present during the calendar year in question. It also takes into account the number of days, if any, he was present during the two preceding years. As a result, and alien individual who was never present as many as 183 days in any calendar year, could nevertheless be held to be a "resident" of the United States for tax purposes if he were present more than relatively short periods of time over a 3-year period.

The Substantial Presence Test contained in H.R. 3475 is so stringent and restricting that an alien individual would meet the test if he is present only 91 days in the current year and 91 days in each of the 2 preceding years. It is respectfully submitted that this test results in a substantive change in the tax law which is unnecessary and unfair to alien individuals who, for any reason, do not want be residents of the United States. The Substantial Presence Test (Section 501 in its entirety) should be deleted from H.R. 3475.

II. THE "APPLICABLE MULTIPLIERS" USED IN THE SUBSTANTIAL PRESENCE TEST GIVE TOO MUCH WEIGHT TO THE NUMBER OF DAYS PRESENT IN THE PRECEDING YEARS

If the Substantial Presence Test is not deleted from H.R. 3475, I respectfully urge that the "applicable multipliers" be reduced so as to give less weight to the number of days an alien individual may have been present during the two preceding years.

As provided in the Bill, the test would be met if the sum of the number of days an individual was present during the current year and the two preceding calendar years (when multiplied by the applicable multiplier) equals or exceeds 183 days, to wit:

Days present:	*Multiplier*
Current year	1
1st preceding year	⅔
2d preceding year	⅓

Applying the above multipliers, an alien individual would meet the test if he spent more than 91 days in the United States each year. This appears to be an unreasonable restriction, and in some instances would result in unnecessary hardship.

If the Committee elects to keep the Substantial Presence Test in the bill, I recommend that the multipliers be reduced so as to permit an alien individual to be present at least 120 days each year without being in jeopardy of meeting the test, as follows:

Days present:	*Multiplier*
Current year	1
1st preceding year	⅓
2d preceding year	⅙

Proponents of the Substantial Presence Test might argue that the bona fide nonresident is protected by the exception to the Substantial Presence Test applicable to individuals who are present in the United States during less than one-half of the current year and where "closer connection to a foreign country" is established. While the Substantial Presence Test is an objective criterion based solely upon numbers of days, the exception to the test is based upon subjective criteria which cannot always be predetermined by the alien.

III. MEDICALLY AND MENTALLY INCAPACITATED PERSONS SHOULD BE EXEMPT FROM THE SUBSTANTIAL PRESENCE TEST

The bill properly exempts commuters and certain other alien individuals such as foreign government-related persons, teachers, trainees and students for that portion of the year such individuals are present, subject to limitations. I recommend that H.R. 3475 be amended to also permit medically and mentally incapacitated persons to be exempt for that portion of the year such individuals are present in the United States, subject however to the same limitations as apply to teachers and trainees, i.e., exempt in the current year unless such person also was exempt for any 2 calendar years during the preceding 6 calendar years.

Exempting medically and mentally incapacitated alien individuals would certainly not jeopardize the revenue of the United States and would allow incapacitated alien individuals the opportunity to obtain medical treatment and solace from mental anguish from the unique facilities available only in the United States. It also would allow medically disabled aliens who may have close relatives residing in the United States to be cared for by those relatives without placing their nonresidence tax status in jeopardy.

IV. NEED FOR A TRANSITION RULE

As now provided in H.R. 3475, the amendment made by Section 501 is applicable to taxable years beginning after December 31, 1983 [Section 501(b)]. A transition rule is necessary to phase in the Substantial Presence Test for the following reasons:

(a) Nonexempt alien individuals who for whatever reasons may have sojourned in the United States for fewer than 183 days but more than 91 days in 1982 and 1983 without intention of becoming residents and without having been aware of the provisions of H.R. 3475 and the "Substantial Presence Test" might unwittingly find themselves unable to visit the United States more than a very few days in 1984 without meeting the test. To avoid this unanticipated and in some cases harsh and unreasonable result, the Bill should contain a transition rule pursuant to which the Substantial Presence Test would not take into account the number of days an alien individual was present in the United States prior to the effective date of the amendment, i.e., if the amendment becomes effective for years commencing after December 31, 1983, the test for 1984 would take into consideration only the number of days an alien individual is present during that years. In 1985, the test would include days present in both 1985 and 1984, subject to the applicable mutipliers. Finally, in 1986, the test would be fully phased in and would include days present in 1986 as well as 1985 and 1984, subject to the applicable multipliers.

(b) Another compelling reason for a transition rule is the problem of records. Some alien individuals who were present during parts of 1982 and 1983 would have inadequate records to prove which days they were present, because prior to the introduction of H.R. 3475 there would have been no particular reason for the alien to have kept such records, provided he was not present more than 182 days in any of those calendar years.

In summary, it is respectfully submitted that Section 501 should be deleted in its entirety from H.R. 3475, or in the alternative:

1. That the applicable multipliers set forth in the amendment be reduced from two-thirds for the first preceding year and one-third for the second preceding year to one-third for the first preceding year and one-sixth for the second preceding year;
2. That alien individuals who are medically or mentally incapacitated be granted the same exemption as that granted teachers and trainees; and
3. That a transition rule be adopted to phase in the Substantial Presence Test over a three year period.

○